

198-11

BY THE COMPTROLLER GENERAL

**Report To The Chairman,
House Committee
On Ways And Means
OF THE UNITED STATES**

**IRS Could Better Protect U.S. Tax
Interests In Determining The Income
Of Multinational Corporations**

When multinational corporations price transactions with their subsidiaries, they often have the opportunity to take advantage of disparate corporate tax rates by shifting income. Ideally, such prices are adjusted by IRS under Code Section 482 to those for similar transactions between unrelated parties--the so-called "arm's length standard." However, IRS often has difficulty identifying a true arm's length price on which to base adjustments.

In its review of current IRS examination data on 519 U.S. multinationals, each having assets over \$250 million and having engaged in transactions with its foreign subsidiaries, GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income were based on a true arm's length price. The remaining adjustments were based on estimated prices constructed by IRS using complex guidelines prescribed by the Department of the Treasury--guidelines which have caused administrative burden and uncertainty both for IRS and taxpayers.

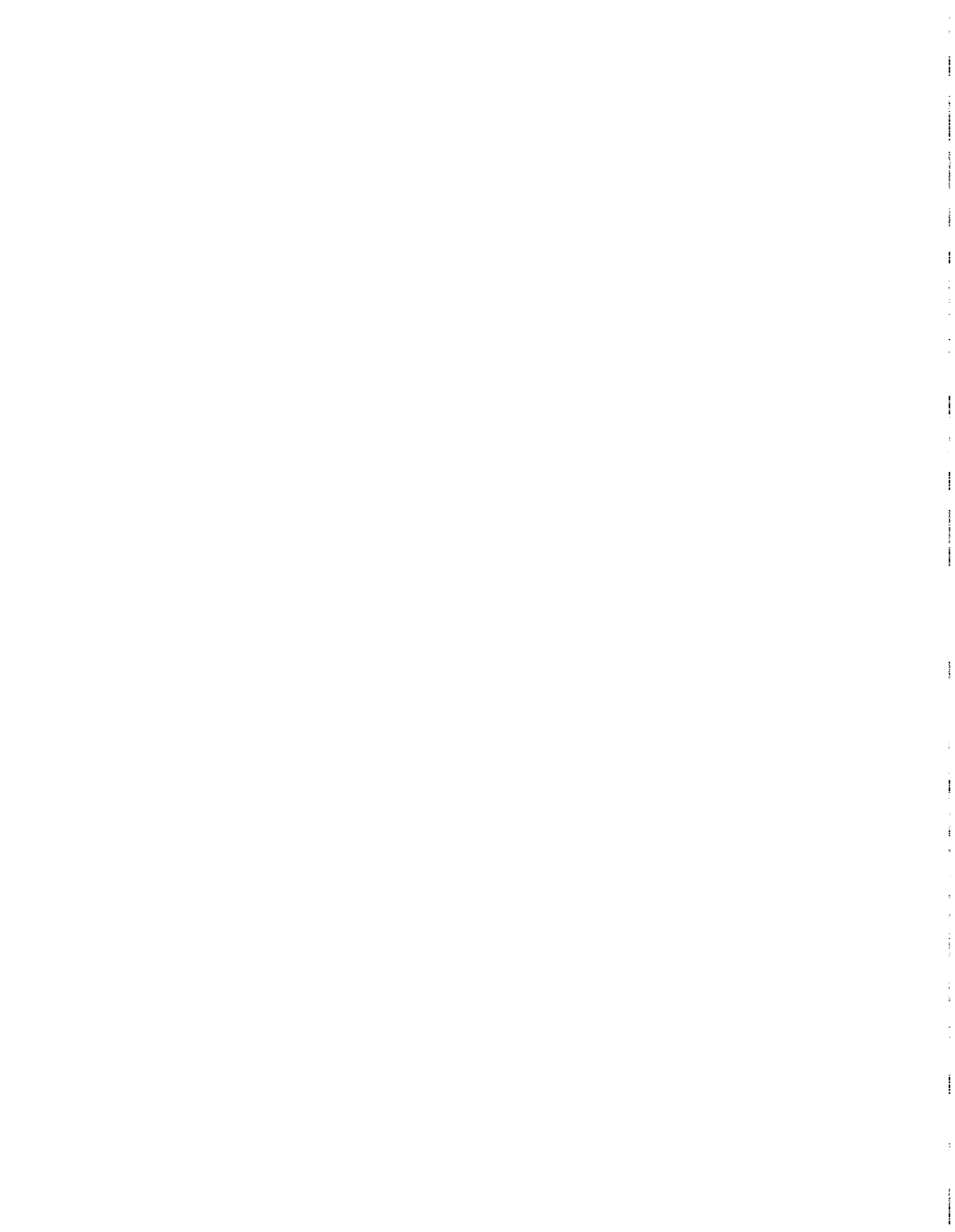
The number and volume of complex international intercorporate transactions as well as the amounts of income involved continue to grow. So that IRS will be able to make more informed decisions in deploying its limited resources, GAO recommends ways for IRS to get a better measure of corporate compliance regarding arm's length pricing. GAO further recommends that Treasury begin a study to ascertain whether the process of enforcing section 482 can be made easier to administer and more certain for all concerned.



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SEPTEMBER 30, 1981





COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-202972

The Honorable Dan Rostenkowski
Chairman, Committee on Ways
and Means
House of Representatives

Dear Mr. Chairman:

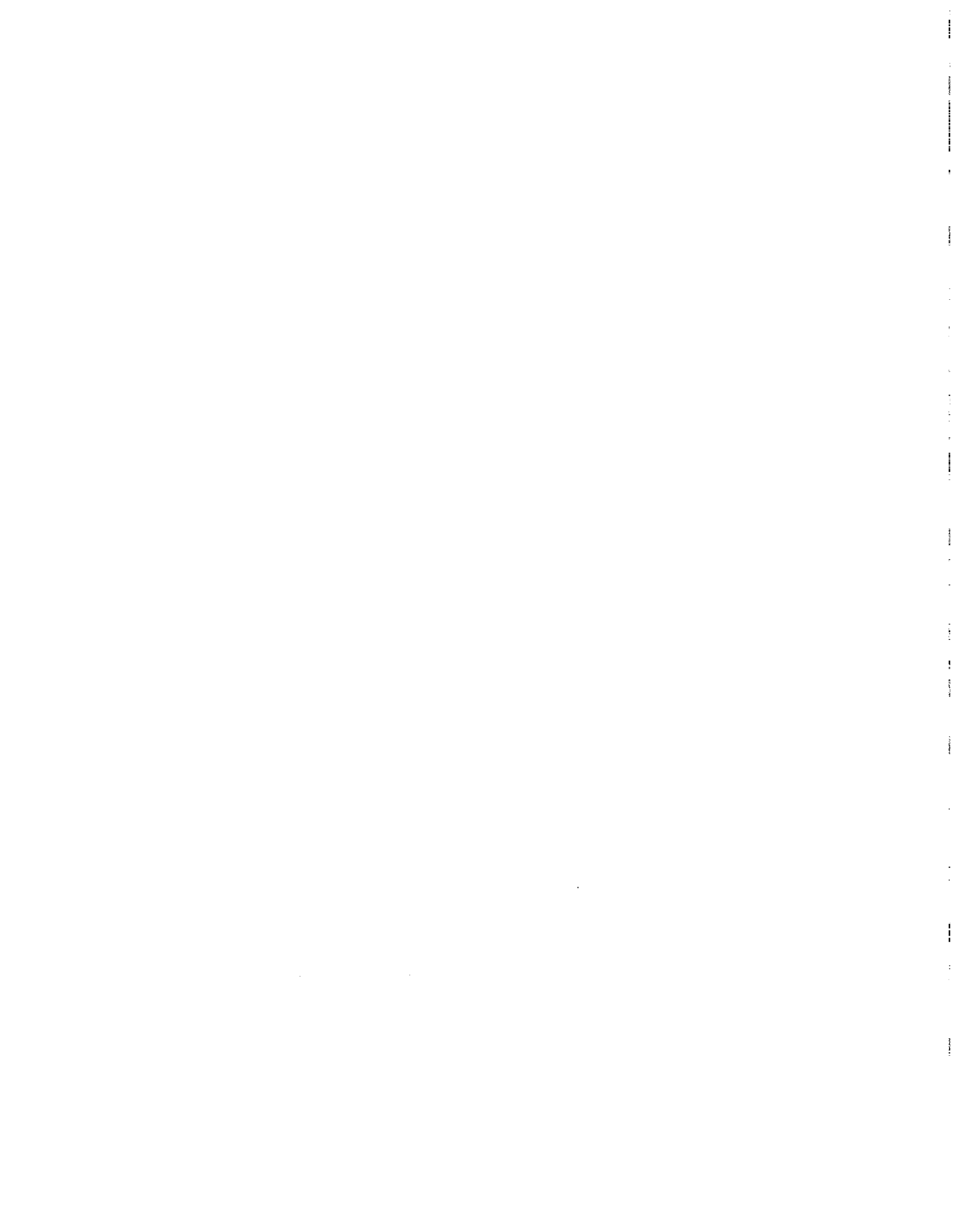
This report, the first of a series in response to the prior Chairman's request, deals with the Internal Revenue Service's administration of Internal Revenue Code Section 482 when auditing multinational corporations. It discusses specific changes which would improve the Service's enforcement of the existing section 482 regulations. It also explores the larger question of whether more fundamental changes in the section 482 regulations together with additional approaches to taxation of multinational corporations could alleviate some of the uncertainty and administrative burden presently experienced by the Service and corporate taxpayers. Both the Service and the Department of the Treasury generally agreed with our recommendations for improving enforcement of the existing regulations. Both Treasury and IRS, however, expressed reservations concerning our recommendation that Treasury study the feasibility of alternatives to the existing regulations. In so doing, both agencies, we believe, minimized the seriousness of the difficulties which section 482 enforcement has presented and continues to present all affected parties.

As arranged with your office, we are sending copies of this report to other Congressional committees; the Director, Office of Management and Budget; the Secretary of the Treasury; the Commissioner of Internal Revenue; and other interested parties.

Sincerely yours,

A handwritten signature in cursive script that reads "Milton J. Arnold".

Acting Comptroller General
of the United States



D I G E S T

Multinational corporations have both the incentive and the opportunity to shift income between jurisdictions to take advantage of disparate corporate tax rates. One incentive is minimization of taxes. The opportunity lies in the pricing of interorganizational transactions. Obviously, possession of incentive and opportunity does not axiomatically lead to abuse--but to tax administrators, American and foreign, it represents a vulnerability to guard against.

IRS, however, has not yet developed baseline information on the incidence and magnitude of multinational corporation noncompliance in terms of improper shifting of income. Thus, IRS has no sound basis for determining the amount of audit resources to be assigned to address the problem, nor for gauging the success of those resources that are applied to it.

Further, IRS enforcement difficulties are compounded by the complexities involved in measuring the amount of income misallocated in those instances where this is believed to have occurred. Ideally, interorganizational pricing is to be adjusted to that for similar transactions between unrelated parties--the so-called "arm's length standard."

However, in the modern economic system of multinational corporate business, a true arm's length price can rarely be identified. When an arm's length price cannot be identified, Department of Treasury regulations for Internal Revenue Code Section 482 provide both the corporate taxpayer and the IRS examiner some guidance for arriving at a constructed price. The regulations and the resulting enforcement

process, however, create an unacceptable level of uncertainty and a significant administrative burden both for corporate taxpayers and IRS examiners.

For example, there is often no similar transaction on which to establish an arm's length price. In these instances, the Treasury regulations do not provide corporate taxpayers with sufficient certainty for planning their financial strategies and considering the tax consequences of their pricing of intercorporate transactions. IRS, faced with the same lack of certainty, must construct an estimated price for adjustment purposes. Both corporate taxpayers and IRS examiners have characterized the end result of the adjustment process as being unpredictable.

The Chairman of the House Ways and Means Committee asked GAO to study section 482 enforcement. GAO reviewed current IRS examination data on 519 U.S. multinational corporations, each having assets over \$250 million and each having engaged in transactions with their foreign subsidiaries. GAO found that only 3 percent (12 of 403) of IRS' total recommended section 482 adjustments to reported income for such transactions were based on a true arm's length price. These adjustments amounted to 3 percent (\$7.4 million of a total \$277.5 million increase) of the total income adjusted for section 482 issues. The tax impact of the total \$277.5 million in adjustments, while not known precisely, can be estimated using a corporate tax rate of 48 percent at roughly \$133.2 million. (See p. 29.)

While IRS has only limited resources, the number and volume of complex international intercorporate transactions as well as the amounts of income involved continue to grow. In the short term, IRS and Treasury should, GAO believes, make several specific improvements in the way they presently administer section 482. In addition, IRS should consider ways to get a measure of corporate noncompliance regarding arm's length pricing, and Treasury should begin a study to ascertain whether ways exist to make section 482 enforcement easier to administer, more certain, and more equitable for all concerned. (See pp. 24 and 53 to 54.)

IRS CAN IMPROVE ITS CURRENT
SECTION 482 ENFORCEMENT ACTIVITIES

IRS needs more management information than it now has to measure what it is doing to enforce section 482 against what needs to be done. Lacking such information, IRS cannot determine with reasonable assurance the impact of its current efforts nor adjust its strategy as may be necessary to make the best use of its limited resources.

Considerable information is available within IRS concerning IRS' enforcement activities and the operations of multinational corporations, but this information has not been analyzed to answer management's needs. The case-by-case results of IRS' section 482 enforcement activities are documented in various reports prepared during the examination and appeals processes. Information on the operations of multinational corporations is also available to IRS from the Form 2952 which must be submitted by U.S. corporations for each foreign subsidiary they control. (See pp. 9 to 11.)

Other information IRS needs is not so readily available. For example, IRS needs a better idea of the extent of noncompliance with section 482 regulations that exists within the universe of multinational corporations.

IRS has, in the past, shown that it can respond to similar problems in developing management strategies where unknown factors exist. IRS now needs to focus its expertise on ways to obtain a better measure of the total noncompliance with section 482 that exists in the multinational corporate universe. (See p. 11.)

CRITICAL REPORTING REQUIRE-
MENTS SHOULD BE EXTENDED

IRS examiners use the form 2952 as their starting point for most examinations involving international transactions. Data provided on this form is critical to the successful identification of many section 482 adjustments. Section

6038 of the Internal Revenue Code authorizes IRS to require this information only from U.S. parent corporations, but similar information is also needed for U.S. subsidiaries of foreign parents. In 1974 there were 6,538 controlled U.S. corporations with assets totaling more than \$76 billion. GAO believes that having similar information readily available for these types of corporations would enhance IRS' identification and examination of section 482 issues in international transactions between U.S. subsidiaries and their foreign parents. (See pp. 18 to 20.)

TREASURY SHOULD ADJUST THE
SAFE HAVEN RATE AS NECESSARY
TO MORE CLOSELY REFLECT THE
REAL COST OF BORROWING

Another needed change concerns the use of the safe haven interest rate, a fixed rate of interest which IRS examiners are permitted to use in lieu of an arm's length price in certain types of transactions as a basis for making income adjustments. The economic climate since 1968 has produced rapidly changing interest rates on the open market. The safe haven interest rates established by Treasury have not kept pace. (See pp. 15 to 16.)

GAO's analysis showed that 83 of the 84 section 482 adjustments involving loan or advance transactions made between August 1972 and June 1975 in its sample were based on a safe haven interest rate of 5 percent. During the period when these adjustments were made, the prime interest rate was always higher than the 5 percent rate, ranging from a low of 5.25 to a high of 12 percent. Treasury implemented a new, higher adjustment rate of 12 percent in July, 1981. This new rate has already been overtaken by the continuous rise in the cost of money which has seen the prime rate reach about 20 percent. (See p. 17.)

Safe haven interest rates which are substantially lower than the open market rate can result in U.S. corporations reporting less income for tax purposes. Further, such safe haven rates are unfair from the perspective of those U.S. corporations which cannot use them. Thus, GAO believes Treasury should adjust the safe haven rate as often as necessary to make the rate realistically reflect the cost of borrowing on the open market. (See pp. 23 to 24.)

ADMINISTERING THE ARM'S LENGTH STANDARD
UNDER CURRENT REGULATIONS IS UNCERTAIN
AND BURDENSOME TO BOTH IRS AND TAXPAYERS

Making income adjustments using the arm's length standard has posed administrative burdens on both IRS and corporate taxpayers. Because of the structure of the modern business world, IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. A constructed price is at best an estimate. Because Treasury regulations do not provide sufficient guidance, corporate taxpayers lack reasonable assurance concerning how income on intercorporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers.

The current regulations provide some guidance for those instances in which an arm's length price cannot be identified but, too frequently, the examiner must use considerable judgment in dealing with data that does not directly relate to the specific situation at hand. Adjustments in which an examiner was able to identify an arm's length price resulted in only 3 percent (\$7.4 of \$277.5 million) of total adjusted income and constituted only 3 percent (12 of 403) of all section 482 adjustments in GAO's sample. Adjustments for 87 percent of total adjusted income were based on the safe haven rules and various alternative techniques permitted by the regulations. The remaining adjustments were arrived at by methods which could not be determined from available documentation or were not applicable to the arm's length standard. (See p. 29.)

Whether or not an arm's length price is obtainable, administering the regulations is a complex process. An examiner must identify questionable transactions, perform a functional analysis, and search for a comparable uncontrolled price. If such a price is not identifiable, the examiner must construct one using alternative techniques. The process as a whole thus creates administrative burden and a degree of uncertainty that is unacceptable for both examiner and taxpayer. (See pp. 36 to 40.)

SHOULD SECTION 482 ADJUSTMENTS BE
MADE MORE CERTAIN AND LESS BURDENSOME?
TREASURY SHOULD SEEK THE ANSWER

For some time, parties affected by and knowledgeable about arm's length adjustments--corporate taxpayers, courts, experts in the field, and officials at IRS--have criticized section 482 enforcement under the current regulations on the basis that (1) the analytical approach to determining arm's length prices often leads to unreasonable results and (2) the examinations require extensive corporate expense and labor. In addition, a substantial body of expert opinion and several court decisions have also criticized the high degree of burden and uncertainty posed by the current regulations. (See pp. 43 to 47.)

IRS examiners told GAO they believe that, under the current regulations, some potential section 482 adjustments are not being developed. They stated that section 482 work is a "high risk venture" where much audit work can result in little additional tax. They pointed out that, because of this, some examiners might not develop a section 482 adjustment because of the difficulty involved in reaching an agreement on an arm's length price or on the basis for making the adjustment. IRS examiners attributed this situation to both the difficulties in the enforcement process and the time it takes to do the work. (See pp. 40 to 43.)

GAO's statistics on the section 482 adjustments IRS made can be interpreted to lend some credence to the examiners' comments. For example:

- Only 200 of the 519 multinational corporations in GAO's sample had section 482 adjustments involving their foreign subsidiaries.
- The bulk of the total \$277.5 million was concentrated in only a few of the 403 total adjustments. Eleven of the 403 adjustments accounted for over one-half of the \$277.5 million.
- Adjustments involving the sale of tangible property, the category of intercorporate transaction where the largest amounts of revenue are at issue, were also concentrated.

Thirty-five U.S. parents and 89 of their foreign subsidiaries experienced adjustments on tangible property sales of \$4.4 billion. The other 12,248 foreign subsidiaries of the 519 U.S. parents experienced no adjustments to a total of \$28.1 billion in intercorporate sales transactions. (See p. 42.)

Neither GAO nor IRS knows how much noncompliance exists, nor how many more adjustments IRS should have made. However, given the difficulty inherent in administering section 482 through the current Treasury regulations, the examiners' statements, and the statistics on the adjustments IRS made, it can reasonably be concluded that the potential for greater enforcement exists.

In the early 1970s, Treasury considered several regulation changes in response to criticism made at that time. The changes, however, were not implemented. Today the need is even greater for Treasury to consider revising the regulations than it was a decade ago. A 1981 study undertaken at the joint request of IRS, Treasury, and the Department of Justice has also recommended revising the regulations to reduce administrative burden and increase certainty, thus lending support to GAO's conclusions (p. 43.)

Tax experts and corporate taxpayers have suggested that Treasury reconsider the appropriateness of the arm's length standard in an economic world more complex than that which existed when the standard was adopted in 1934. For example, one alternative suggested is to expand the use of the safe haven concept, thus creating greater certainty. Another alternative frequently suggested is the use of formulas for apportioning income in certain situations. Apportionment formulas are presently used by 45 States, and some experts believe these formulas, when applicable, reflect market realities better than the arm's length standard. (See pp. 50 to 52.)

A major objection to the use of formula apportionment across national borders is that tax treaties between the U.S. and other nations specify the arm's length standard for adjusting corporate income. For the U.S. to adopt a different method could result in multinational

corporations incurring double taxation. GAO recognizes the significance of this problem. (See p. 52.)

GAO suggests that IRS consider ways to get a measure of noncompliance and that Treasury be the focal point for a study to identify ways to improve the guidance provided concerning section 482 enforcement. After IRS and Treasury have completed this work, Treasury should be able to make an informed decision as to whether and how to change the section 482 regulations. (See p. 53.)

RECOMMENDATIONS TO THE COMMISSIONER
OF INTERNAL REVENUE

IRS presently lacks sufficient information to assess the effectiveness of its section 482 enforcement and design future strategy with informed judgment. The need to make informed strategy decisions will assume even greater importance in the future as the number of inter-corporate transactions continues to grow in disproportion to IRS' limited resources. To place the Service in a position to make informed decisions regarding how best to deploy those resources, GAO recommends that the Commissioner of Internal Revenue:

--Aggregate and analyze existing data from a management perspective, consider ways to get a measure of noncompliance, and establish procedures for continuously assessing the appropriateness of IRS' section 482 enforcement strategy.

GAO also made other recommendations to improve IRS' enforcement activities (p. 25.)

RECOMMENDATIONS TO THE SECRETARY
OF THE TREASURY

The current Treasury regulations for implementing code section 482 create uncertainty and administrative burden for both IRS and corporate taxpayers. Since better guidelines are needed, GAO recommends that the Secretary of the Treasury:

--Begin a study to identify and evaluate the feasibility of ways to allocate income under

section 482, including formula apportionment, which would lessen the present uncertainty and administrative burden created by the existing regulations.

GAO also recommended that the Secretary:

--Adjust the safe haven interest rate as frequently as necessary to realistically reflect the current costs of borrowing on the open market.

RECOMMENDATION TO THE CONGRESS

To provide IRS the authority to require the information it needs from foreign-controlled U.S. corporations, GAO recommended that the Congress amend section 6038 of the Internal Revenue Code to further provide that every United States person, as presently defined by the code, shall furnish such information as the Secretary may prescribe by regulation with respect to any foreign corporation which controls such person.

AGENCY COMMENTS AND GAO'S EVALUATION

Treasury agreed in principle with GAO's conclusions and recommendations concerning the need to more frequently adjust the safe haven interest rate. Treasury stated that a change in the current safe haven rate was made on July 1, 1981, and it anticipated that the rate in the future will be adjusted periodically so as to reflect major changes in interest costs.

Both Treasury and IRS generally agreed with GAO's recommendations concerning specific improvements that need to be made to current section 482 enforcement procedures. However, both agencies expressed disagreement with the recommendation that Treasury undertake a study to identify ways to lessen the uncertainty and administrative burden created by the existing regulations. In so doing, both agencies, GAO believes, minimized the seriousness of the difficulties which section 482 enforcement has presented and continues to present all affected parties. As GAO noted, uncertainty as well as the administrative difficulties and burden on all parties affected by section 482 enforcement have been documented in all previous studies on the subject, the most recent being a January 1981 study

undertaken at the joint request of the IRS Commissioner, the Assistant Attorney General, and the Assistant Secretary of the Treasury for Tax Policy.
(See pp. 54 to 57.)

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ABBREVIATIONS

CEP	Coordinated Examination Program
DISC	Domestic International Sales Corporation
GAO	General Accounting Office
IEP	International Enforcement Program
IER	International Examiner's Report
IRC	Internal Revenue Code
IRS	Internal Revenue Service
RAR	Revenue Agent's Report
WHTC	Western Hemisphere Trade Corporation

CHAPTER 1

INTRODUCTION

In this age of the supercompany with its sophisticated pattern of worldwide operations and financial dealing, there is perhaps no more difficult problem for the tax administrator than the examination of the tax returns of multinational corporations."

This statement by a former Commissioner of the Internal Revenue Service (IRS) 1/ puts in context the difficulty of auditing a multinational corporation in the 1980s. While taxation of international investments has always presented problems, these have become more important in recent years as the growing international economy has produced more and larger multinational corporations.

A multinational corporation can be defined as a cluster of corporations of diverse nationality joined together by ties of common ownership and responsive to a common management strategy. 2/ Unlike a corporation which conducts business in only one country, a multinational corporation possesses the business ability to create global markets for its technology, products, etc., as well as plan the flow of its funds irrespective of national borders. Multinational corporations routinely engage in many intercorporate transactions with their foreign subsidiaries. 3/ The individual corporations, parent and subsidiaries, often sell each other machinery, parts, components, and finished goods. They may also lend each other money, lease each other equipment, and provide each other a wide range of managerial, research, and/or development services. For tax purposes, prices must be assigned to these intercorporate transactions.

1/"Auditing Multinational Corporations," Address to the Assembly of Inter-American Center of Tax Administration, Ottawa, 13 June 1975.

2/"Multinational Corporations and Income Allocation under Section 482 of the Internal Revenue Code," Harvard Law Review, 89 (April 1976), 1202-38.

3/For purposes of this report a foreign subsidiary (what IRS calls "a controlled foreign corporation") is a foreign corporation which is owned more than 50 percent by a U.S. corporation.

Through these intercorporate transactions, multinationals have numerous opportunities to avoid U.S. taxes. By charging unrealistic prices in the exchange of goods and services, a corporation can transfer profits earned in one country to another. For example, an artificially high transfer price for goods or services purchased from a foreign subsidiary can reduce a parent U.S. corporation's profits and, thus, the tax revenue to the U.S.

IRS USES SECTION 482 OF THE INTERNAL
REVENUE CODE TO PREVENT IMPROPER SHIFTING
OF INCOME BY MULTINATIONAL CORPORATIONS

IRS uses section 482 of the Internal Revenue Code (IRC) to prevent improper shifting of income by multinational corporations. When multinational corporations engage in income-seeking transactions that cross national borders, market forces may not control the price. Rather, the price set by a parent corporation in a transaction with its subsidiary may be designed to shift income to the subsidiary in order to gain a tax advantage. Section 482 authorizes IRS to allocate income, deductions, or credits among related corporations when such allocation is necessary to prevent tax evasion or to clearly reflect the income of each.

Section 482 had its origin in Section 240(d) of the Revenue Act of 1921 which authorized the Commissioner of IRS to "consolidate the accounts" of related trades or businesses for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among related trades or businesses. The Senate Finance Committee believed section 240(d) was necessary to prevent the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized to conduct business in foreign countries. In the Revenue Act of 1928, section 240(d) was changed to section 45 and subsequently became section 482 during the 1954 revisions to the IRC. No substantive changes to the law were made either in 1928 or 1954.

Section 482 does not specify a method for IRS to use in making income allocations. In 1934 the Department of the Treasury adopted the "arm's length standard" for allocating income. This apparently was based on the League of Nations adoption in 1928 of a model bilateral convention which stated that controlled subsidiaries of multinational corporations were to be treated for tax purposes as independent legal entities doing business with the rest of the enterprise on an independent or "arm's length" basis. The arm's length standard thus requires that the transfer prices set by multinational corporations for goods or services exchanged with or between their foreign subsidiaries be the same as the price that would have been acceptable to independent parties dealing with each other at arm's length. IRS first publicized its intent to use the arm's length standard to

enforce section 482 in regulations issued in 1934. These regulations, however, did not provide satisfactory guidance to corporations and IRS examiners because they contained little more than a statement of policy and a series of definitions.

IRS had little need to change the regulations, however, because it seldom used them. By 1961 this situation changed as IRS began directing its attention to U.S. corporations which had established foreign manufacturing and marketing subsidiaries in the years following the end of World War II. Since 1961 IRS has made ever-increasing use of section 482 to allocate income to the U.S. when multinational corporations shifted income to foreign corporations through non-arm's length transactions. With this increased enforcement, IRS has experienced numerous problems in using the regulations to determine arm's length prices.

In 1962 the Congress suggested that Treasury explore the possibility of developing and issuing regulations that would provide additional guidelines and formulas for the allocation of income and deductions in cases involving section 482. Following this congressional mandate, Treasury issued regulations in 1968 that left unchanged the basic arm's length standard and provided additional guidelines, but no formulas, for applying section 482 to certain types of transactions. The 1968 regulations elaborated on the application of the arm's length standard for five categories of intercorporate transactions--sales of tangible property, transfer or use of intangible property, use of tangible property, performance of services, and loans or advances. For each category, the 1968 regulations set certain rules which are to be followed in determining the arm's length transaction price. These regulations are still in effect.

The most serious problem with the current regulations is that when IRS examiners are unable to find a comparable arm's length price or use the safe haven rules for an intercorporate transaction the examiners must use considerable judgment in further implementing the regulations. In doing so, examiners must analyze extensive data collected from corporations, data that often does not directly relate to the specific situation at hand. The taxation of intercorporate transactions thus creates uncertainty for corporations and imposes a significant administrative burden both on them and on IRS.

MULTINATIONAL CORPORATIONS--A
COMPLEX AND RAPIDLY EXPANDING
AREA OF TAX ADMINISTRATION

The favorable economic climate since the Second World War has brought about a tremendous expansion of U.S. corporations into international business. This expansion of international business coupled with the growing complexity of multinational

corporations has presented IRS with an increasingly larger and more difficult task in enforcing section 482. The growth in the number, size and volume of U.S. corporations' international business transactions can be seen from the following statistics:

- The number of multinational corporations increased from 2,642 in 1962 to 4,388 in 1972, an increase of 66 percent. During this same period, their foreign subsidiaries increased from 12,073 to 29,221.
- Multinational corporations with \$250 million or more in U.S. assets increased from 364 in 1968 to 666 in 1974, an increase of 83 percent.
- Intercompany transactions between the 364 U.S. multinational corporations and their foreign subsidiaries amounted to \$24 billion in 1968. By 1974 intercompany transactions for the 666 corporations totaled \$104 billion, an increase of 333 percent.

In addition, the total volume of international business controlled by U.S. multinational corporations is significant. To cite only a few examples, a 1973 United Nations report showed that U.S.-based multinational corporations controlled more than one-half of the petroleum industry in Belgium; about three-fifths of the food, tobacco, oil refining, metal manufacturing, instrument engineering, computer, and technical manufacturing industries in the United Kingdom; and more than 15 percent of the production of semiconductors and 80 percent of electronic data processing equipment in the European community. Since 1973 the volume of U.S. multinational involvement in other countries has continued to increase, and there is no reason to think this trend will not continue.

IRS ORGANIZATION AND PROGRAMS TO ENFORCE SECTION 482

In every examination that IRS performs of tax returns filed by corporations that control or are controlled by foreign corporations, section 482 is a potential issue. The Assistant Commissioner (Compliance) is responsible for the examination of multinational corporate tax returns. The Assistant Commissioner carries out this responsibility through the IRS Examination Division and Office of International Operations. The Examination Division audits tax returns of the large U.S. multinational parent corporations and the large U.S. corporations controlled by foreign parent corporations. The Office of International Operations audits the returns of smaller U.S. corporations controlled by foreign parents.

In 1966 IRS established its Coordinated Examination Program (CEP) after concluding that its traditional "one case/one agent" audit approach lacked the necessary expertise and other requisites for properly examining large corporations. When we began our work, corporations were included in the CEP if they had \$250 million or more in gross assets or, if the corporation was a utility or financial institution, \$1 billion or more in assets. 1/ Generally corporations in the CEP have their returns examined for each tax year. Under the CEP, the tax return of a corporation is assigned to a case manager in the IRS district where the corporation's principal business headquarters is located. The case manager then controls the examination of all corporations that are part of the business enterprise, regardless of location. The case manager reviews the operations of the total organization, determines the scope and depth of the examination, and assembles an audit team. The team is composed of revenue agents and other needed specialists, including international examiners and economists. As of March 31, 1981, IRS had 232 international examiners and 14 economists.

The international examiners are part of IRS' International Enforcement Program (IEP), which IRS created in addition to the CEP as a means to improving section 482 enforcement. IRS' international examiners are trained in international tax issues. IRS has established procedures intended to result in the assignment of international examiners only to those examinations which present the more difficult and complex international issues. While they are assigned to 13 districts which IRS has designated "key" districts, international examiners work on examinations in all 58 IRS districts. International issues are handled by a regular IRS examiner (revenue agent) if an international examiner is not assigned to a particular examination. When assigned to an examination, the international examiner is responsible for preparing a report on the international tax issues examined.

Since establishing the CEP and IEP, IRS has taken action to supplement both programs. These actions, some taken in response to recommendations by the House Ways and Means Oversight Subcommittee and some at IRS' own initiative, include

--designating industry specialists under the industrywide examination program to keep IRS abreast of trends and developments in selected industries so that tax issues

1/Effective October 1, 1979, IRS established a point system for identifying and including corporations in the CEP. Points are given for eight characteristics, such as total assets and gross receipts. Corporations which are assigned points above a fixed score are included in the CEP.

within these industries may be more effectively identified and developed;

- increasing the number of economists employed and decentralizing them to those districts whose workloads include many multinational corporations;
- requiring more upfront planning so as to make a more informed selection of tax issues to be reviewed during examinations;
- creating a program to exchange information with certain treaty partner countries to better understand the worldwide operations and practices of selected multinational industries;
- establishing a program with certain treaty partner countries to simultaneously examine the tax return of a multinational corporation; and
- establishing centralized transfer-pricing units, which control the price determination of section 482 adjustments for crude oil, bauxite/alumina, iron ore, coal, and copper products.

By establishing the CEP, IEP, and related special programs, IRS has acted to address problems inherent in section 482 enforcement. The problems, however, remain and will become increasingly troublesome as the number and complexity of multinational corporations continues to grow. In chapter 2 of this report we suggest some specific changes which would improve IRS enforcement of the existing section 482 regulations. These suggested changes focus on management issues and administrative procedures. In chapter 3 we explore the larger question of whether more fundamental changes in the section 482 regulations together with additional approaches to taxation of multinational corporations could alleviate or even eliminate some of the problems presently experienced by IRS and corporate taxpayers.

OBJECTIVES, SCOPE, AND METHODOLOGY

We reviewed the administration of section 482 to determine the extent and severity of problems IRS was experiencing in allocating the income of multinational corporations. We examined IRS policies, procedures, and practices for allocating multinational corporate income and discussed section 482 enforcement with international examiners and their supervisors at seven IRS districts. At the IRS national office, we discussed section 482 enforcement with staff economists, Examination Division officials, and representatives of the Office of the Deputy Chief Counsel (Technical). We reviewed studies and articles prepared by IRS

and other nongovernmental tax experts and examined significant court cases.

We also studied IRS' administration of section 482 by reviewing the results of its examinations of 519 multinational corporations included in the CEP. These 519 multinational corporations were those for which IRS was able to provide us with the most usable examination data available as of September 30, 1979. For 200 of these corporations, IRS had recommended section 482 adjustments totaling \$277.5 million to transactions between U.S. and foreign corporations. IRS had also recommended other section 482 adjustments totaling \$330 million. We did not include these adjustments in our statistics because the transactions did not involve foreign subsidiaries. We developed our statistics by extracting information from the international examiners' reports and revenue agents' reports for the subject examinations.

A more complete discussion of our review objectives and methodology is contained in chapter 4.

CHAPTER 2

IMPROVEMENTS NEEDED IN IRS' PROCEDURES

FOR ENFORCING SECTION 482

By creating the CEP, IEP, and various special programs, IRS has improved its enforcement of section 482. However, assuming that IRS continues to examine intercorporate transactions under the current regulations, there are still several actions IRS can take to make its section 482 enforcement more effective.

At present IRS could improve the way it monitors the effectiveness of its section 482 enforcement and designs future strategy. The need to make informed strategy decisions will assume even greater importance in the future as the number of intercorporate transactions continues to grow in disproportion to IRS' limited resources. To best deploy those resources, IRS needs to better analyze its existing data from a purely management perspective, obtain a measure of the extent of corporate noncompliance with the arm's length standard, reaffirm its existing enforcement strategy or design a new strategy based on that analysis, monitor results of its enforcement activities, and make adjustments as appropriate.

One specific improvement IRS can make in using its resources concerns its economists. To find an arm's length price for certain types of transactions, it is necessary to make an economic analysis. IRS can maximize the effectiveness of its economists by requiring that they participate in examinations where, under present IRS criteria, the participation of an economist is left to the case manager's discretion. In their audit work, economists develop information about the corporate taxpayer which, as IRS has discovered from its industrywide examination program, can be useful to teams auditing corporations with similar operations or products. IRS should expand this communication process beyond its industrywide program. As part of their audit work, economists should determine whether the issue being developed may exist at other corporations. If so, this information should be routinely communicated to the appropriate audit teams.

In certain types of 482 adjustments, the examiner does not make an economic analysis to determine a comparable arm's length price but must instead use a fixed rate of interest known as the "safe haven rate." More easily administered than other types of section 482 adjustments, the safe haven interest rate also provides greater certainty to the IRS examiner and corporate taxpayer. However, since 1968 interest rates have fluctuated widely, and Treasury has not adjusted the safe haven rate often enough to reflect the costs of borrowing on the open market. A safe haven rate significantly below market prices can result in reduced

revenue to the Treasury and is unfair to those corporate taxpayers whose transactions do not meet the safe haven criteria. Treasury should adjust the rate so that it corresponds more realistically to market prices.

IRS also needs legislation to amend code section 6038 so that IRS can require that the information most useful in administering section 482 be reported by U.S. subsidiaries with foreign parents as is presently required only for U.S. parent corporations. Extending the reporting requirements in this way would make it possible for examiners to more quickly and easily identify potential section 482 adjustments involving these types of corporations. IRS examiners told us that this information as reported on the form 2952 by U.S. parent corporations is particularly helpful in this regard.

IRS also needs to clarify the wording of those sections of the form 2952 which require information on sales and purchases of stock in trade and on intercorporate loan transactions. IRS realizes that the form 2952 does not clearly require all the information an examiner needs for planning purposes at the beginning of an audit. IRS should clarify the information it wants reported and, in the interim, notify its examiners of the shortcomings in the wording of the present form 2952.

IRS NEEDS TO DEVELOP
MANAGEMENT INFORMATION AND
EVALUATE ENFORCEMENT STRATEGY

IRS needs more management information than it now has to measure what it is doing to enforce section 482 against what needs to be done. Lacking such information, IRS cannot measure the impact of its current efforts nor adjust its strategy to make the best use of its limited resources. Much of the information IRS needs for its planning exists but has not been accumulated and analyzed from a management perspective. Other needed information is not as readily available.

IRS has twice undertaken special studies to accumulate information on the results of its section 482 enforcement activities, but neither study will produce all the information management needs to assess current and plan future strategy. In January 1973 Treasury released an IRS study of section 482 enforcement statistics based on examiners' reports completed in 1968 and 1969. In October 1979 IRS began accumulating information from current examinations for a second, more comprehensive, study of section 482 enforcement. The study is collecting data on (1) the extent that section 482 is an examination issue, (2) whether or not IRS is recommending adjustments, and (3) the types and amounts of adjustments recommended. This information enables IRS to identify frequency and trends of section 482 adjustments according to geographic location. Recognizing the benefits of

this type of data, IRS plans to continue to collect and analyze this data as a permanent part of the IEP.

However, to adequately evaluate section 482 enforcement, IRS needs to obtain and use information on (1) the universe of multinational corporations and the location of their worldwide operations, (2) the extent that these corporations conduct intercorporate business, (3) the extent that intercorporate transactions may not be in compliance with the arm's length standard, and (4) the extent to which its enforcement activities is succeeding in recouping the tax loss. The IRS study will provide only information relative to the last point, the results of its current enforcement activities.

Considerable information is available within IRS concerning IRS' enforcement activities and the operations of multinational corporations, but we found no indication that this information has been aggregated to answer all of management's needs. The case-by-case results of IRS' section 482 enforcement activities are documented in various reports prepared during the examination and appeals processes. These reports contain information on the instances where section 482 is an examination issue; the number, amount, and type of transactions recommended for adjustment; the method used to make the adjustment; and the results of taxpayers' appeals to IRS' proposed adjustments.

Also, U.S. corporations which control foreign subsidiaries must submit with their tax return a form (form 2952) showing information on their multinational operations. On the form, the U.S. corporation must report its dealings, e.g., tangible and intangible property transactions, interest payments, loans, dividends, etc., with its foreign subsidiaries. The U.S. corporation is also required to provide the foreign subsidiaries' profit and loss statement, balance sheet, and analysis of changes in surplus accounts.

IRS aggregates some of this data but we found no indication that it is used to reach management decisions on how best to use its resources. IRS' Statistics Division publishes a Statistics of Income report which contains statistical tables summarizing information from the corporations' multinational operations as reported on the forms 2952. In doing this, the Statistics Division also generates listings of the data reported by each multinational corporation in the CEP. These listings could be quite useful to IRS in evaluating its section 482 enforcement activities.

For example, examiners and managers using the listings could quickly identify all subsidiary corporations operating in a particular tax haven country, involved in a particular industry, or having unusually high profits. IRS could also determine the location of those corporations where an adjustment was made, the

amounts of adjustments made involving tax haven countries, and the results of cases that were appealed. Through such analyses, IRS could search for common denominators to use in targeting its limited resources.

Other information IRS needs is not so readily available. For example, IRS needs to know the extent of noncompliance with section 482 regulations that exists within the universe of multinational corporations. IRS has, in the past, shown that it can respond to similar problems in developing management strategy where unknown factors exist, such as in the area of the unknown extent of noncompliance among individual taxpayers. IRS now needs to focus its expertise on ways to obtain a more certain measure of the total noncompliance with section 482 that exists in the multinational corporate universe.

We recognize that section 482 enforcement is a complex management task. Given the fact that IRS is limited in its examination resources and will in all likelihood remain so, it cannot cover the entire universe of potential section 482 adjustments on multinational corporate tax returns. Thus, IRS management must on a more informed basis evaluate and adjust its enforcement strategy to assure that it makes the best possible use of its examiners and economists.

IRS NEEDS TO MAKE GREATER USE OF ITS ECONOMISTS

To develop adjustments using the arm's length standard, the examiner's normal expertise in accounting and the law must be supplemented with an expertise in economics. The IRS manual on section 482 enforcement shows that examiners must look behind the books and records of a corporation to discover the economic or commercial realities of the market place and of the complex transactions. Instead of the examiner's prime concern focusing on forms, invoices, books, and accounts, it shifts to the products transferred and the functions required to effect that transfer. This functional analysis requires economic expertise. At present, IRS has 14 economists available on a request basis to assist its examiners.

Present procedures for involving an economist in a section 482 adjustment are as follows. According to the Internal Revenue Manual, a request for assistance should be made as soon as it is determined that an economist is needed. Case managers are responsible for identifying which examinations would benefit by having an economist on the audit team. A case manager's decision on whether or not to request an economist is usually made after considering the recommendation of the international examiner on the audit team. IRS' manual stipulates that requests should be limited to potential adjustments of \$500,000 or more, or to

examinations where resolutions of the issue will have significant precedent value. According to the manual, requests for assistance should be made when an economist can assist (1) in the identification and evaluation of potential issues, or in the recognition of the economic data needed to support the issues; (2) in the analysis, evaluation, and interpretation of economic and statistical information; and (3) in determining whether an adjustment is based on sound economic concepts, is reasonable in amount and is consistent with recommendations made in similar situations. Economists may also participate in conferences between IRS personnel and corporate officials if economic data are going to be discussed.

In our review of IRS examinations, we found that case managers frequently did not use economists in examinations where, according to IRS' dollar criterion, their assistance may have been needed. Fifty-seven of the 519 examinations in our data base encompassed 69 section 482 adjustments that met IRS' dollar criteria for requesting assistance from economists. However, economists actually participated in developing only 6, or 9 percent, of these adjustments.

In discussing the use of economists, 29 of 42 examiners and their supervisors we talked with told us that economists are very helpful in developing section 482 adjustments involving the identification and use of comparable transactions for pricing purposes. Various examiners and supervisors told us that economists were not used more frequently due to:

- The additional time required by economists to develop an adjustment.
- The belief by some examiners that the expertise of economists was no better than that of the examiners.
- The reluctance of examiners to request economic assistance when the need for an economist is not identified until the examination is well underway.

To find out whether assistance from economists in more adjustments would have been beneficial, we discussed with IRS economists 23 of the 63 (69-6) adjustments where, according to the dollar criterion in the IRS manual, an economist's assistance could have been requested but was not. We did not discuss the other 40 adjustments because we believed the reports on these adjustments contained insufficient information to permit a judgment on whether the participation of an economist was necessary.

We discussed the 23 cases with four economists. The Chief of the Coordinated Programs Section, who is responsible for the CEP, suggested that we deal with these economists in particular

because they were his senior economists and devoted most of their time and effort to CEP examinations. In only 1 of the 23 adjustments did the economists believe the issue was developed such that their assistance was not needed. For the remaining 22 adjustments, the economists believed they could have contributed to better development of the adjustments. They stated that their contribution could have included:

- More complete and reliable analysis of economic data. For example, IRS appeals officials asked an economist for assistance in one unagreed adjustment because the amount did not seem to have much support or follow logically from the facts presented. In our discussions, the economist told us that had they been involved in the initial development of this adjustment, they could have developed a price which would have been more in line with IRS' previous position on similar adjustments.
- Better development of the comparable data used for determining a price. One adjustment, for example, was based on a comparable price using unrelated licensing agreements which were modified by the examiner to fit the current situation. Corporate officials disagreed with the modification. The economists believed they would have been able to determine (1) whether the licensing agreements were appropriate to use, and (2) whether they could be properly modified to fit the current circumstances.

In discussing the specific adjustments, the economists stated that it was sometimes difficult to determine if the examiner properly developed the comparable price based only on an evaluation of the examiner's report. At times the reports did not contain the "whys" and "hows" of development for the issue. In these instances it was difficult to know whether the problem was in case development or in report writing by the examiner. Notwithstanding, and even though the number of cases we discussed with economists was not large and the issue of economists' participation of necessity involves subjective judgment, we found their logic convincing.

We discussed with the Chief of the Coordinated Programs Section and the Chief of the International Program Section the feasibility of mandatory participation by economists in adjustments where comparable transactions must be analyzed. The officials told us that mandatory participation by economists appeared to be a good idea. The Chief of the International Program Section stated that economists are important to the audit team and their inputs strengthen the audit effort. The Coordinated Examination Program Chief added that while economists' participation in audits has not been substantial in the past, IRS has recently begun a comprehensive education program in an effort to encourage requests for economists' participation. The education program

is designed to make case managers and international examiners more aware of the assistance economists can provide. The program consists of having economists speak at IRS meetings and training classes for examiners and case managers, distributing a pamphlet on the economists' function, and revising IRS manuals to include guidance on the type of assistance economists can provide. Since the education program is still in an early stage, it is too early to evaluate results. The officials stated, however, that mandatory participation could create a need for additional economists.

Because economic analysis appears essential in many section 482 enforcement efforts, a good case can be made that economists' participation should be mandatory in those instances where safe haven rules can not be used. We recognize that mandatory participation would increase the workload for the 14 IRS economists. However, we also recognize that, in some cases, mandatory participation can be accomplished by as little as a telephone contact. IRS is now in the process of implementing the House Ways and Means Oversight Subcommittee recommendation that IRS increase the number of its economists and decentralize them. Requiring mandatory participation should allow IRS management to determine whether additional economists are needed and, if so, how many.

DATA DEVELOPED BY ECONOMISTS SHOULD
BE MADE AVAILABLE ON A WIDER SCALE

In addition to requiring mandatory participation of economists in section 482 adjustments where safe haven rules do not apply, IRS could make better use of the data the economists develop by more widely disseminating that data to its audit teams. By doing so, section 482 enforcement can be improved and audit time lessened.

In developing a section 482 adjustment, economists frequently develop large amounts of information on a corporation and its industry. The type of information developed includes

- comparable prices in the industry which can be applied to the situation in question at the specific corporations,
- analysis of the functions performed by each party involved in the intercorporate transaction and in the comparable transaction,
- data such as average hourly wage and/or unit assembly costs for the corporation, and
- research on overall operations of corporations similar to the corporation being examined.

Recognizing that this information can be useful on other examinations, IRS established procedures for economists to provide recommendations on potential issues and other data to the industry specialists who coordinate IRS' various industrywide examinations. The industry specialization program presently covers only 13 industries. Thus, a large part of section 482 enforcement involves corporations in industries not covered by the industrywide program. The examinations of corporations in these industries could also benefit from the use of the economists' information.

Specifically, information on a section 482 issue developed by an economist participating on a particular examination could justify recommending an examination of the same issue at another corporation in the same industry or establishing an industrywide examination of the issue for an industry not currently in the industrywide program. Even if the information developed by an economist was not significant enough to justify establishing an industrywide examination of the issue, it could be of sufficient importance and usefulness to be communicated to case managers and examiners responsible for examining tax returns of other corporations.

The economists and the Chief of IRS' Coordinated Program Section agreed that economists could make a valuable contribution by identifying potential issues for examinations at corporations having similar operations or products. They also agreed that in these instances communicating issue-related information developed by economists to case managers and examiners would prove useful. We believe IRS should formalize this process.

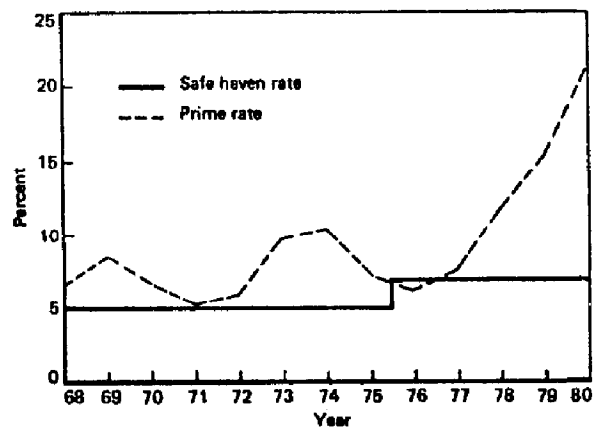
SAFE HAVEN INTEREST RATE USED
IN ADJUSTMENTS INVOLVING LOANS
AND ADVANCES SHOULD MORE CLOSELY
REFLECT THE OPEN MARKET RATE

Section 482 regulations require that interest be charged on loan and advance transactions made by one corporation to another in the same controlled group. The regulations permit the corporation in certain instances to use either a "true" arm's length interest rate or a rate within a "safe haven" range. (See app. I.) The true arm's length rate is the rate of interest that would have been charged at the time the indebtedness arose in independent transactions between unrelated businesses. If a corporation charges interest within the safe haven range (at the time of our review not less than 6 and not more than 8 percent), no adjustment is considered necessary provided that the corporation is not in the business of making loans or advances of the same general type as the loan or advance transactions made to the related corporation. If, however, the corporation did not charge any interest or charged a rate which did not satisfy the 6 to 8 percent standard,

then the rate used by IRS was 7 percent simple interest. 1/ Use of the safe haven interest rate eliminates the uncertainty to the corporation of whether the rate charged will be considered an arm's length rate by IRS. It also provides IRS examiners with a criterion to use in making adjustments without having to identify comparable arm's length rates.

As shown in the following chart, since 1968 the safe haven interest rate has generally been substantially lower than prime interest rates, which more closely reflect the actual cost of borrowing. This disjunction has occurred because the rate was revised only once between 1968 and 1980--a 12-year period. 2/ Failure to revise the rate to more closely reflect the prime interest rates normally results in substantially lower interest income reported by U.S. corporations for tax purposes.

COMPARISON OF SAFE HAVEN AND PRIME INTEREST RATES



Note: On July 24, 1975, the rate was increased from 5 to 7 percent.

1/If the corporation can justify a more appropriate rate than the safe haven rate, that rate is considered the arm's length rate and may be used.

2/On July 1, 1981 Treasury implemented a new, higher adjustment rate of 12 percent. The safe haven range was raised to rates not less than 11 and not more than 13 percent.

Our analysis showed that 83 of the 84 section 482 adjustments involving loan or advance transactions made between August 1972 and June 1975 were based on the safe haven interest rate of 5 percent. These 83 adjustments, amounting to \$12.6 million, were made because the lending corporations charged no interest on the intercorporate loans, advances, or delinquent accounts receivable. During the period when these adjustments were made, the prime interest rates were always higher than the 5 percent rate, ranging from a low of 5.25 percent to a high of 12.0 percent.

We discussed the need for more frequent revisions of the safe haven interest rate with officials of IRS' Office of the Deputy Chief Counsel (Technical) and Treasury's Office of Tax Analysis. The officials agreed that the interest rate has historically been too low when compared to market interest rates and should be revised upward. They stated that the procedure for changing the rate was time-consuming and normally took about 2 years. The official from IRS explained that the procedure required:

- The Director, Legislation and Regulation Division to provide the Assistant Secretary for Tax Policy a memorandum explaining the trends in interest rates and that the safe haven rate should be revised.
- The Assistant Secretary to agree that a change is warranted and to recommend that a study project be initiated.
- The Commissioner of IRS and the Executive Office of the Secretary of the Treasury to approve the study project.
- The Commissioner of IRS and the Executive Office of the Secretary of the Treasury to approve the proposed regulation change reflecting the revised rate.
- The proposed regulation change to be published in the "Federal Register" and public hearings held.
- The Department of the Treasury to issue the new regulation change.

Although the safe haven interest rate has only been changed once in 12 years, Treasury and IRS have periodically reviewed the rate in relation to prime commercial rates and the average yield of 5-year U.S. Treasury securities. It appears from Treasury and IRS documents that the rate was not changed more often because (1) the difference between the safe haven rate and the two rates used for comparison was not considered significant enough to require a regulation change and (2) the procedure for such a change requires substantial work and time.

The official from Treasury agreed that the safe haven adjustment rate should correspond more closely to open market prices. He stated that he believed a self-adjusting interest rate should be established for the section 482 regulations. The official said that in some instances where rates are set by regulations, the problem of rate fluctuation is handled by the regulations permitting a change without a policy review. The official said that Treasury has plans to consider implementation of the self-adjusting rate in the future.

INFORMATION RETURNS SHOULD
BE REQUIRED OF FOREIGN
CONTROLLED U.S. SUBSIDIARIES
AND SOME PORTIONS OF THE
RETURN SHOULD BE CLARIFIED

When reviewing transactions between a U.S. parent and its foreign subsidiaries for potential section 482 adjustments, the data contained on the "Information Return with Respect to Controlled Foreign Corporations" (Form 2952) is of great importance to IRS (see app. II). In fact international examiners consider the form 2952 a prime source of information in identifying potential section 482 adjustments and in planning their examination work. However, the information return is required only of U.S. parent corporations for their foreign subsidiaries. It is not required of U.S. subsidiaries controlled by foreign parent corporations. IRS officials and examiners stated that requiring an information return from foreign-controlled U.S. subsidiaries would help in identifying potential section 482 adjustments and reduce the time needed to review their operations.

In addition, there are two requirements on the return which do not clearly communicate the information IRS needs. The first requirement involves reporting the amount of sales and purchases of stock in trade among foreign subsidiaries of U.S. parents. The other requirement concerns the reporting of loans. Because the form does not clearly communicate, IRS must in both situations do additional work to develop this information or risk not making necessary adjustments.

Information returns should be required
of foreign-controlled U.S. subsidiaries

Section 6038 of the Internal Revenue Code authorizes IRS to require that an information return be completed by all U.S. parent corporations showing information on transactions with their foreign subsidiaries. This return must be submitted with the parent corporation's tax return. In the return, U.S. parent corporations must show the amount of receipts and payments in transactions involving stock in trade, property rights, services, loans, rents, royalties, etc. that occurred between (1) the U.S.

parent corporation and each foreign subsidiary, (2) each U.S. subsidiary and foreign subsidiary of the U.S. parent corporation, and (3) each foreign subsidiary.

Foreign-controlled U.S. subsidiaries conduct the same type of transactions with their foreign parents and other controlled corporations of their foreign parents. However, the extent of these intercorporate transactions need not be reported to IRS through the information return.

Consequently, IRS does not have this information available when initially planning the work to be performed during the examination of these corporations. When planning their examination work, international examiners told us that they use the transaction information to identify potential non-arm's length transactions among the controlled corporations. The examiners provide time in their audit plans to analyze such transactions. Not having the transaction data available when beginning the examination delays the planning process and the starting of detailed examination work for international tax issues.

Because an information return is not required for controlled U.S. corporations, examiners normally request intercorporate transaction information from corporate officials when beginning the examination. This is a time-consuming process that entails requesting specific data and documents from the corporation, waiting for the corporation to provide the information requested, and reviewing the information before an examiner can complete the audit plans and begin the examination of specific issues. According to the examiners, having this information available with the return would assist them in (1) identifying what international tax issues should be examined, (2) preparing the audit plan, (3) becoming more efficient in developing the issues, and (4) reducing the time needed to complete the examination.

At least one IRS employee has formally recognized this need. A supervisor of international examiners recommended in 1977, under IRS' Employee Suggestion Program, that foreign-controlled U.S. corporations be required to file an information return. The supervisor stated that the information return, if provided, would be as valuable in examining foreign-controlled U.S. subsidiaries as it is in examining U.S. parent corporations. The supervisor believed that requiring the return would reduce examination time, thus resulting in a salary cost savings per audit, and also improve international enforcement of foreign-controlled U.S. subsidiaries.

The requirement that U.S. parent corporations with foreign subsidiaries submit information returns was established in 1960 when section 6038 of the code was enacted. Department of Treasury and IRS officials told us that, in their opinion, this

reporting requirement was not extended to controlled U.S. corporations because at that time

--there were few foreign-controlled U.S. corporations and reporting was not considered necessary, and

--the Congress was primarily concerned about the foreign tax credit instead of section 482 enforcement.

Today, the situation concerning foreign-controlled U.S. corporations is quite different than when section 6038 was enacted. In 1959 there were only 1,006 foreign-controlled U.S. corporations with assets totaling \$8.4 billion. By 1974 the number of controlled U.S. corporations had increased to 6,538 with assets totaling more than \$76 billion. Further, Department of Commerce figures show that foreign direct investment in the U.S. increased at an estimated average annual rate of 6.5 percent between 1959 and 1972 and exceeded 20 percent annually during 1973 and 1974.

IRS officials also expressed the opinion that requiring foreign-controlled U.S. corporations to prepare the information return would not place an added burden on the corporations because the corporations are currently providing similar data in response to examiners' requests. They stated that the need for this information is becoming increasingly important due to the large increase in the number of foreign-controlled U.S. corporations.

Form 2952 requirements for reporting stock in trade and loan transactions need clarification

As presently worded, the information return (form 2952) contains two requirements for information which do not adequately communicate to the corporation the data that IRS needs. The first requirement involves the reporting by U.S. parent corporations of sales and purchases of stock in trade among their foreign subsidiaries. The second requirement concerns the reporting of intercorporate loan transactions. Multinational corporations can shift income by conducting both types of these transactions at other than arm's length terms. According to the IRS manual, examiners are to review these transactions when examining the U.S. parent corporation's tax return. If non-arm's length transactions are identified, the examiners are to prepare a section 482 adjustment.

U.S. parent corporations report on form 2952 the amounts of receipts and payments in transactions among their foreign corporations. The problem in reporting transactions involving the "sales and purchases of stock in trade" stems from a clause on the form which reads "except in the ordinary course of business

where neither party to the transaction is a U.S. person." When the subsidiary corporations involved in the transactions are all foreign, the wording of the clause is inadequate as it essentially fails to require reporting of all such transactions. This lack of information on sales and purchases among controlled foreign corporations hampers IRS' efforts and may cause IRS to overlook some section 482 adjustments.

U.S. corporations are also required to report on the form the amounts of receipts and payments involved in intercorporate loan transactions. The problem with this requirement is a clause on the form which reads "* * * other than open accounts which arise and are collected in the ordinary course of business." Thus, corporations are required to report only the amount of loan transactions which were closed during the year. They are not required to report open loan accounts. Without this information, examiners may be unaware of loans which have been outstanding for years. IRS officials believe the lack of loan information hampers their enforcement efforts because they do not get a complete picture of the extent of loan transactions. Examiners must do additional work to identify this information or risk not making necessary adjustments.

IRS officials told us that, for the past few years, they have been aware of the inadequacies in the wording of these two areas. They stated that these inadequacies have been mentioned during training courses for international examiners. The officials said that about 6 years ago IRS began developing a new "form 5471" to consolidate the information required on form 2952 and that of other forms. The new form, as currently proposed, would obtain the data IRS needs. However, the officials could not tell us if, or when, the new form will be issued. As an interim measure, the officials said that revisions to the current form 2952 could be made when the form is next printed. Current supplies of the form should last to 1982.

IRS should either revise the form 2952 when it is printed or issue the new consolidated form. Until such time as one or the other of these actions is taken, IRS should inform its examiners of the shortcomings in the information they are receiving on the present form 2952.

TIMELY ACCESS TO CORPORATE RECORDS BEING STUDIED BY IRS

International examiners must have access to corporate books and records in a timely manner if they are to be effective in enforcing section 482 as well as other code sections, and if they are to meet IRS' objective of only 3 open tax return years for CEP corporations. However, international examiners and other IRS officials stated that corporate records frequently are not provided in a timely manner.

IRS officials discussed the records problem with staff from the House Ways and Means Oversight Subcommittee during their review of IRS' CEP program in late 1977. The Commissioner of IRS also testified on the problem before the subcommittee in September 1977. Because of these discussions, the subcommittee noted in its April 1978 report that IRS' authority to require appropriate books and records, contained in Internal Revenue Code Sections 905, 964, and 6001, provides no penalties in the event corporate officials fail to adequately comply with these sections. The study recommended that IRS determine whether penalties for noncompliance with these sections would be helpful. If so, IRS was to communicate its findings to the Department of the Treasury so that legislative proposals could be made to the Congress.

In partial response to the subcommittee's recommendations, IRS issued a manual supplement in October 1979 to ensure that its employees understood the agency's authority under the three sections to obtain books and records. IRS is also presently conducting a study to determine whether additional authority is needed to obtain more timely access to corporate information and records.

Since IRS' study was in progress while we were conducting our review, we looked at the approach IRS was taking. The study approach appeared sound. For this reason, we did not include the potential access problem in our work.

CONCLUSIONS

The past few decades have seen a tremendous expansion in the number and complexity of multinational corporations and the financial transactions between multinational parents and subsidiaries. This, in turn, has produced correspondingly complex enforcement problems for IRS. Recognizing this, IRS has devoted considerable attention to improving its process for examining multinational corporate tax returns. But more needs to be done, especially in the area of enforcing code section 482.

IRS must place itself in a better position to make informed decisions for maximizing the use of its limited resources. To do this, IRS needs to assess its current enforcement strategy for section 482 by using information on (1) the universe and locations of multinational parent corporations and their subsidiaries, (2) the extent that these parents and subsidiaries conduct intercorporate financial transactions, (3) the extent that these transactions may not be in compliance with the arm's length standard, and (4) the extent to which IRS enforcement activities are recouping the tax loss. With this baseline data, IRS will have information on the incidence and magnitude of multinational non-compliance in terms of improper shifting of income. IRS can then

reaffirm its present strategy or make an informed decision regarding a new approach. It must then monitor the results of its enforcement activities to adjust its overall strategy if necessary.

One way IRS can improve its enforcement of section 482 and the use of its limited resources is by making greater use of its economists. Economists can contribute significantly to the development of successful section 482 adjustments where it is necessary to establish an arm's length price. Their expertise brings an added but necessary dimension to the audit process. Given this, they could productively be involved in the development of all such adjustments.

From a practical standpoint, however, it would seem prudent to establish some criteria for economists' participation in recognition of their limited number and IRS has in fact established such criteria. While we did not evaluate the appropriateness of that criteria, we noted that the dollar criterion was not met in 50 of the 119 cases in our data base where the adjustment was determined on the basis of comparable uncontrolled transactions or one of the alternative methods. Also, IRS has recognized the importance of economic analysis in section 482 adjustments and is presently conducting a comprehensive education program to encourage examiners to request the assistance of economists. Accordingly, IRS should reassess the appropriateness of its criteria and require mandatory participation by economists in each adjustment that meets the criteria established.

IRS also needs to make wider use of information developed by its economists. In making audit adjustments, economists develop substantial information about the corporate taxpayer. IRS has found through its industry specialization program that communicating this type of information to audit teams examining corporations with similar operations or products is a highly effective technique. This technique should be expanded beyond the industry specialization program. When developing an adjustment, the economists should determine whether the issue may exist at other corporations. If so, the information should be given to other IRS audit teams examining corporations with similar operations or products.

Another needed change concerns the use of safe haven interest rates. The economic climate since 1968 has produced rapidly changing interest rates on the open market. The safe haven interest rates established by Treasury have not kept pace. Keeping the safe haven interest rates substantially lower than the open market rate can result in U.S. corporations reporting less income for tax purposes. Further, from an equity standpoint, failure to adjust the safe haven rates upward is unfair to those U.S. corporations who cannot use them. Thus, Treasury should adjust

the safe haven rates as often as necessary to make the rates realistically reflect the cost of borrowing on the open market.

Changes should also be made regarding the form 2952, which IRS examiners use as their starting point for most examinations involving international transactions. Examiners consider the data provided on this form critical to the successful identification of many potential section 482 adjustments. Section 6038 of the Internal Revenue Code authorizes IRS to require this information only from U.S. parent corporations, but similar information is also needed for U.S. subsidiaries of foreign parents. Having this information readily available would enhance the identification and examination of section 482 issues in international transactions between U.S. subsidiaries and their foreign parents.

Another problem concerning the form 2952 is that the form does not clearly describe the information IRS needs concerning sales and purchases of stock in trade and intercorporate loan transactions. IRS is aware of, but has not yet corrected, this problem. IRS should clarify the description of the needed information either by revising the form 2952 when existing supplies are depleted or by issuing a new consolidated form which is currently being developed. In the interim, IRS should notify its examiners of the shortcomings in the information called for by the present form 2952.

RECOMMENDATION TO THE CONGRESS

We recommend that the Congress amend Section 6038 of the Internal Revenue Code to further provide that every United States person, as presently defined by the code, shall furnish such information as the Secretary may prescribe by regulation with respect to any foreign corporation which controls such person.

RECOMMENDATION TO THE SECRETARY OF THE TREASURY

We recommend that the Secretary of the Treasury adjust the safe haven interest rate as frequently as necessary to realistically reflect the current costs of borrowing on the open market.

RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

We recommend that the Commissioner of Internal Revenue:

- Aggregate and analyze existing data from a management perspective, consider ways to get a better measure of noncompliance, and establish procedures for continuously

assessing the appropriateness of IRS' section 482 enforcement strategy.

- Reassess the appropriateness of IRS' criteria for requesting economists' participation in section 482 adjustments and require that participation be mandatory for all adjustments that meet the criteria established.
- Require IRS economists to evaluate whether the information they develop in one examination would be useful in other examinations and establish a procedure for communicating such information to other audit teams which examine corporations having similar operations or products.
- Clarify the description of the information that corporations should report concerning the sale and purchase of stock in trade and intercorporate loan transactions either by revising the form 2952 when current supplies are depleted or by issuing the new consolidated form currently being developed. In the interim, IRS should notify its examiners of the shortcomings in the present form.

AGENCY COMMENTS AND OUR EVALUATION

Treasury agreed in principle with our conclusions and recommendations concerning the need to more frequently adjust the safe haven interest rate. Treasury stated that a change in the current safe haven rate was made on July 1, 1981, and it anticipated that the rate in the future will be adjusted periodically so as to reflect major changes in interest costs. Treasury added that it had considered the possibility of using a self-adjusting rate but believed such a rate would present problems for taxpayers.

IRS generally agreed with our conclusions and recommendations for improving its section 482 enforcement procedures. Agreeing that it should obtain and analyze information from a management perspective, IRS said it intended to expand its ongoing section 482 study to meet this need. IRS further agreed to reassess its criteria for requesting economists' assistance in developing section 482 adjustments and to mandate their participation in all adjustments meeting the criteria. IRS also said that it would evaluate its present procedures for communicating information developed by its economists to revenue agents and make changes in these procedures provided that disclosure restrictions are not violated.

With respect to our recommendation concerning the form 2952, IRS agreed to notify its examiners of the form's shortcomings but stated that changing the current wording may require a change

to section 6038 of the tax regulations. The need to provide better instructions to both taxpayers and IRS examiners is clear. Thus, we think that IRS should take the necessary steps to fill this need.

CHAPTER 3

HOW CAN SECTION 482 ENFORCEMENT BE MADE

MORE CERTAIN AND LESS ADMINISTRATIVELY

BURDENSOME? TREASURY SHOULD SEEK THE ANSWER

Adjusting multinational intercorporate transactions for tax purposes under current section 482 regulations is administratively burdensome for both IRS and the corporate taxpayer. Moreover, the considerable amount of judgment necessary in most income adjustments recommended under the regulations creates uncertainty. In recent years, the regulations have been a source of dissatisfaction to all parties affected, including the courts.

In essence, section 482 enforcement is criticized because the theory on which it rests no longer corresponds to the realities of intercorporate transactions. In theory, a section 482 adjustment should be made when income reported for a multinational intercorporate transaction varies from the comparable uncontrolled price of a similar transaction between two unrelated businesses. The comparable uncontrolled price is the arm's length price for the transaction. In practice, however, IRS examiners have difficulty finding a comparable uncontrolled price for most transactions. Of the examinations we reviewed, only 3 percent (12 of 403) of IRS' recommended adjustments between parents and foreign subsidiaries were based on comparable uncontrolled prices. The income adjusted through these arm's length prices amounted to only 3 percent of the total income adjusted for section 482 issues.

The regulations provide some guidance for those instances where an arm's length price cannot be identified but, too frequently, the examiner must use considerable judgment in analyzing extensive data which often does not directly relate to the specific situation at hand. To the extent that the facts do not directly relate, the adjustment price becomes estimated.

Tax experts and corporate taxpayers have suggested that Treasury reconsider the appropriateness of the arm's length standard in an economic world more complex than that which existed when the standard was adopted in 1934. For example, one alternative suggested is the use of formulas for apportioning income in certain situations. Apportionment formulas are presently used by the States, and some experts believe these formulas, when applicable, reflect market realities better than the arm's length standard. Another alternative frequently suggested is to expand the use of the safe haven concept, thus, creating greater certainty.

We recognize that some difficult international issues might be raised if the U.S. adopted new approaches to taxing multinational transactions. We, do not, however, believe that this prospect should deter Treasury from studying whether alternatives, or a combination of alternative and present approaches, could make section 482 enforcement administratively easier, more certain, and more equitable for all concerned.

IRS MAKES RELATIVELY FEW
ADJUSTMENTS ON THE BASIS OF
COMPARABLE INDEPENDENT PRICES

The 1968 regulations issued by Treasury provided IRS with guidelines for making section 482 income adjustments. The regulations explain the arm's length standard, the principle underlying section 482 adjustments, as follows:

"The 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 a 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."

For example, uncontrolled transactions with respect to the transfer of tangible property are defined as

- sales by an member of the controlled group to unrelated businesses,
- sales to a member of the controlled group by unrelated businesses, and
- sales in which the businesses are not members of the controlled group and are not related to each other.

IRS first tries to identify independent transactions which are exactly comparable or so nearly identical to the transaction in question as to have no effect on price. In the absence of such independent transactions, the regulations permit IRS to use other alternative techniques to apply the arm's length standard. The alternative techniques generally involve constructing adjustment prices based on independent transactions that fall short of being exactly comparable or nearly identical to the transaction in question. The regulations provide guidelines for making adjustments to the following five categories of intercorporate transactions: (1) sale of tangible property, (2) transfer or use of intangible property, (3) loans and advances, (4) performance of services, and (5) use of tangible property (rent).

The regulations permit the use of alternative techniques for adjustments in all five categories of transactions when a comparable uncontrolled price cannot be found. The regulations also require the use of safe haven rules under certain conditions for transactions in categories (3), (4), (5).

Our study showed that few section 482 adjustments are made using prices based on comparable uncontrolled transactions. As shown in the following table only 3 percent of the 403 IRS recommended section 482 adjustments were based on arm's length prices determined through comparable uncontrolled transactions. The 403 adjustments involved 200 of the 519 multinational corporations in our data base and their controlled foreign corporations. 1/

<u>Basis for adjustment</u>	<u>Number of adjustments</u>	<u>Percent</u>	<u>Adjusted amount</u>	<u>Percent</u>
Amounts determined through Comparable uncontrolled transactions	12	3	\$ 7,384,342	3
Alternative techniques	107	26	181,251,869	65
Safe haven rules	<u>240</u>	<u>60</u>	<u>60,410,769</u>	<u>22</u>
Total	<u>359</u>	<u>89</u>	<u>249,046,980</u>	<u>90</u>
Other:				
Not determinable from report (note a)	25	6	7,592,307	3
Not applicable (note b)	<u>19</u>	<u>5</u>	<u>20,855,126</u>	<u>7</u>
Total	<u>403</u>	<u>100</u>	<u>\$277,494,413</u>	<u>100</u>

a/Information not shown in records we examined.

b/Use of section 482 to make adjustments where neither safe haven rules nor arm's length prices were applicable. For example, returning total income to the U.S. because of sham foreign subsidiary.

As shown above, 26 percent of the section 482 adjustments were made using alternative techniques. These require an even greater degree of subjective judgment by the examiner than does

1/IRS also made other section 482 adjustments amounting to \$330 million which involved 235 of the 519 corporations. We did not analyze these adjustments because the transactions did not involve a controlled foreign corporation. However, 200 of the 235 corporations are the same corporations represented in our statistics because they also had adjustments involving their foreign subsidiaries.

the identification of an arm's length price. The income adjusted through alternative techniques amounted to 65 percent of the total adjusted. The tax impact of these adjustments is not known precisely but can be roughly estimated at \$87 million based on a corporate tax rate of 48 percent.

In the next few pages we describe in greater detail the kinds of alternative techniques available to IRS examiners in adjusting income for the five categories of intercorporate transactions. Our discussion shows that the application of alternative techniques where no comparable uncontrolled price can be found creates administrative difficulties and uncertainty for both IRS and the corporate taxpayer. In most cases, the adjustment that results from applying the alternative techniques is based on data that does not directly relate to the specific situation at hand.

Most adjustments involving
the sale of tangible property
involve considerable judgment

IRS considers tangible property adjustments to be the most important of the five categories discussed in the regulations because the largest amounts of revenue are involved. Tangible property adjustments in our data base amounted to 45 percent (\$125.1 of \$277.5 million) of the total income adjusted by IRS under section 482.

When a comparable uncontrolled price for a tangible property adjustment cannot be identified, the regulations direct examiners to apply the resale price method, then the cost plus method, and finally a fourth method defined as "some appropriate method." (See app. III for a description of these pricing methods). These methods must be applied in sequence until an appropriate basis for an adjustment is found.

Our statistics show that IRS was able to identify prices established through comparable uncontrolled transactions in only 15 percent (5 of 34) of its tangible property adjustments. Even more revealing is that the adjustment amounts based on comparable uncontrolled transactions represented only about 2 percent (\$2.3 of \$124.2 million) of the tangible property income which was adjusted by IRS through determinable methods.

<u>Pricing method</u>	<u>Adjustments</u>		<u>Amount</u>	
	<u>Number</u>	<u>Percent</u>	<u>Total</u>	<u>Percent</u>
Comparable uncontrolled transactions	5	15	\$ 2,347,236	2
Resale price method	4	12	7,801,901	6
Cost-plus method	9	26	7,229,240	6
Any other method	<u>16</u>	<u>47</u>	<u>106,796,497</u>	<u>86</u>
Total	<u>34</u>	<u>100</u>	<u>\$124,174,874</u>	<u>100</u>
Not determinable	3		964,019	
Total	<u>37</u>		<u>\$125,138,893</u>	

Information in the reports IRS provided us was not sufficient to determine the pricing method used for 3 of the 37 adjustments. However, only 5 of the remaining 34 adjustments were made using prices obtained from comparable uncontrolled transactions. When comparable uncontrolled transactions could not be identified, IRS examiners most often used the fourth or "any other" method. Thus, 86 percent of the income adjustments resulting from the sale of tangible property were made using that method for which the regulations provide the least guidance.

The following examples taken from reports prepared by IRS economists and international examiners on examination cases we reviewed illustrate the amount of work and the considerable degree of judgment required of an examiner.

Corporation A, a U.S. parent, sold component parts and materials to its foreign subsidiaries. The foreign subsidiaries assembled finished or semifinished devices that they sold back to the U.S. parent. The economist could not identify comparable uncontrolled transactions within the controlled group because the U.S. parent and the foreign subsidiaries made no similar sales to unrelated parties. Also, the economist was unable to find comparable uncontrolled transactions outside the controlled group because the multinational corporation's interaffiliate transactions were in a form contrary to normal trade practices. The economist found that normal trade practices in that industry would have the U.S. parent providing without charge the component parts and materials to the foreign subsidiaries which, in turn, would function as contract assemblers and be paid for the services provided. The economist developed an adjustment based on an analysis of what would be an appropriate amount (labor costs plus profit) to reimburse the foreign subsidiaries for assembling the items sold to the U.S. parent corporation. The economist, in computing the adjustments, used profit margin percentages obtained from

an independent contract assembler that performed work somewhat similar to that done by the foreign subsidiaries. The economist noted that the information obtained from the independent contract assembler was incomplete and incompatible in several important areas.

Corporation B, a U.S. parent, sold chemicals to a foreign controlled distributor corporation at a markup of 10 percent over manufacturing costs. The examiner could not identify comparable uncontrolled transactions within the controlled group because no similar sales were made to unrelated parties. The examiner developed the adjustment based on the gross profit percentages that selected independent (third party) U.S. distributors earned selling the U.S. parent corporation's chemicals. However, the examiner adjusted the independent U.S. distributors' profit percentage using three factors to compensate for differences in the operations of the independent distributors and the foreign controlled distributor. The examiner made the adjustments based on a gross margin of 36.3 percent computed as follows:

<u>Factors</u>	<u>Gross profit percentage</u>
U.S. distributors' gross margin	27.7
Differences in	
Sales function	4.1
Warehousing function	0.5
Markets	<u>4.0</u>
Total	<u><u>36.3</u></u>

The examiner identified the differences in operations after considerable discussion with representatives of the corporation. Because the foreign-controlled distributor was located in a tax haven country, it was to the U.S. parent corporation's benefit to have its foreign distributor's gross profit percentage as high as possible. Therefore, the U.S. corporation officials argued that the different factor percentages should be higher. The examiner stated in his report that the adjustment made could not be tied down to a realistic, factual situation.

As shown below, the results of our analysis of IRS adjustments to sales of tangible property are not dramatically different from those of other studies:

Study	Year of study	Percent of adjustments using pricing method					
		Comparable uncontrolled	Alternative methods				Total
			Resale	Cost Plus	Other	Total	
Conference Board (note a)	1972	28	13	23	36	72	100
Department of Treasury (note b)	1973	21	11	27	41	79	100
Indiana University (note c)	1980	24	14	30	32	76	100

a/Michael G. Duerr, Tax Allocations and International Business: Corporate Experience with Sec. 482 of the Internal Revenue Code, (New York: The Conference Board, 1972). The Conference Board is an independent, nonprofit business research organization.

b/U.S. Department of the Treasury, Summary Study of International Cases Involving Section 482 of the Internal Revenue Code (Washington: Treasury, 1973).

c/Jane O. Burns, "How IRS Applies the Intercompany Pricing Rules of Section 482: A Corporate Survey," Journal of Taxation, 54 (May 1980), 308-14. Dr. Burns, presently of the Graduate School of Business, Indiana University, is a former Vice-President of the American Taxation Association and Treasurer of the American Accounting Association's International Accounting Section.

Adjustments involving the transfer or use of intangible property

Intangible property includes such things as patents, inventions, trademarks, brand names, and technical data. (See app. IV.) Ownership of valuable intangible property can provide a corporation with a competitive advantage and rewards which enable above normal profits.

Similar to adjustments involving tangible property pricing, few intangible property adjustments were based on comparable uncontrolled transactions. IRS recommended 73 intangible property adjustments between U.S. parent corporations and their foreign subsidiaries in the examinations we reviewed. We could not determine the method used in making 18 of the adjustments because the examiner's report did not contain sufficient information. However, only 3 of the remaining 55 adjustments (5 percent) were based on prices obtained from comparable uncontrolled transactions. The 3 adjustments represented about 4 percent (\$2.3 of

\$61.1 million) of the total amount adjusted for intangible property. The remaining 52 adjustments were made by the examiner using an alternative technique. When a comparable uncontrolled price cannot be found for an adjustment involving intangible property, the regulations give the examiner 12 factors to consider in making the adjustment. The use of these factors requires that the examiner construct the adjustment price. Normally, however, an examiner does not have to use all 12 factors before arriving at a basis for the adjustment.

The following example illustrates how a price is constructed by an IRS economist or an international examiner when prices from comparable uncontrolled transactions are not available.

Corporation A, a foreign-controlled U.S. subsidiary, paid a royalty rate of 9 percent on sales of a drug its foreign parent corporation licensed it to manufacture and sell. The examiner could not identify comparable uncontrolled transactions to use in making the adjustment because the foreign parent corporation did not have similar licensing agreements for the drug with unrelated parties. The examiner developed an adjustment that recognized a 5 instead of a 9 percent rate based on his findings that the drug was "second line" rather than "unique and superior" as claimed by the U.S. corporation. The examiner attributed the drug's extremely high sales to sensational advertising and unparalleled promotion by the U.S. corporation. The examiner constructed the 5 percent royalty rate based on the following information.

- a. Discussion with personnel who negotiated the royalty rates indicated that over the years the 5 percent rate had become acceptable to both parties.
- b. For many years a rate of return of 5 percent on a financial investment was considered good in the corporate sector. This factor was one of the main considerations in arriving at a rate acceptable to both parties.
- c. There had been other studies of drug royalty rates which indicated that the most common rate charged was 5 percent.

As a 1979 report by the Organization for Economic Cooperation and Development pointed out, ^{1/} it is difficult to identify comparable uncontrolled transactions since the owner of intangible

^{1/}Transfer Pricing In Multinational Enterprises (Paris: Organization for Economic Cooperation and Development, 1979).

property, particularly the owner of a patent, is essentially the owner of a monopoly right which may not be made available to unrelated businesses.

Most adjustments involving loans and advances, services, and rents are made using safe haven rules

The method most frequently used to make section 482 adjustments in the examinations we reviewed involved the safe haven rules. (See app. I.) Safe haven rules must be used by examiners to determine adjustment prices or rates only when the corporation makes loans and advances, provides a service, or rents tangible property to its foreign subsidiaries, and then only if the corporation does not routinely engage in these types of transactions with other parties. If the corporation is in the business of making loans and advances, providing similar services or renting similar property to unrelated businesses, the examiner cannot use the safe haven rules and must try to obtain a price from a comparable uncontrolled transaction. When safe haven rules can be used, the examiner does not look for a comparable uncontrolled price but immediately refers to the safe haven rules. The regulations, however, allow a corporation to contest an adjustment made by the safe haven rules. If a corporation can support an arm's length price for the transaction, IRS must accept the arm's length price rather than one arrived at using the safe haven rules.

Of the 274 adjustments in our data base involving loans and advances, services, and rents, 240 adjustments (87 percent) were made using the safe haven rules. The amount adjusted using the safe haven rules represented 86 percent (\$60.4 of \$70.3 million) of the total amount of income adjusted by IRS for these three categories of transactions. (See app. V.)

IRS could not use the safe haven rules to determine the adjustment price for the remaining 34 adjustments because the nature of the transaction being adjusted represented an integral part of the corporation's business. The amount adjusted in such instances must be based on an arm's length price. However, similar to adjustments involving tangible and intangible property pricing, few of these 34 adjustments were made based on prices obtained from comparable uncontrolled transactions. Information in the reports we reviewed was not sufficient to determine if comparable uncontrolled prices were used for 4 of the 34 adjustments. However, only 4 of the remaining 30 adjustments were based on comparable uncontrolled prices. The four adjustments represented only 28 percent (\$2.7 of \$9.8 million) of the total income adjusted for these three categories of transactions using techniques other than safe havens.

The regulations do not provide any guidance to examiners for determining the price to use for loans and advances, services, and rents when comparable uncontrolled transactions cannot be identified and safe haven rules cannot be applied. Of the 30 adjustments made by determinable techniques other than the safe haven rules, 28 involved service category transactions between U.S. parents and foreign subsidiaries. Prices for only three of these 28 adjustments were based on comparable uncontrolled transactions. Thus, the remaining 25 service category transactions we reviewed were adjusted solely on the basis of examiner discretion. Income adjusted for the 25 transactions amounted to \$6.8 million.

POTENTIAL ADJUSTMENTS MAY BE MISSED
UNDER CURRENT SECTION 482 REGULATIONS

The administrative complexity produced by the current section 482 regulations may result in potential adjustments not being made. The regulations prescribe a complex and time-consuming process for making adjustments. First, the examiner must identify questionable transactions. If safe haven rules do not apply, the examiner must perform a functional analysis of the transactions, search for comparable uncontrolled prices (which our analysis indicates are rarely obtainable), and then construct comparable uncontrolled prices using judgment to the degree needed. Because examiners work on several cases simultaneously, precise data on the average time required for a section 482 adjustment is lacking. However, our interviews with IRS examiners and the statistics we developed indicate that IRS' limited number of examiners are unable to cover the universe of multinational intercorporate transactions. Thus, given the complexity of the current regulations and IRS' limited resources with which to implement them, there is a need for revised guidelines which could be more easily administered and which would bring greater certainty and less burden to section 482 enforcement.

Questionable transactions warranting
detailed analysis are difficult to
identify

To enforce section 482 under the arm's length standard, IRS must examine in detail the particulars of intercorporate transactions. Because of the large number involved, IRS cannot possibly do this for all transactions between corporations and related foreign subsidiaries. For example, the 519 multinational corporations in our data base generated \$32 billion in sales with about 12,000 foreign subsidiaries. Thus, the first step of IRS' enforcement process is the decision as to which transactions are to be reviewed in detail during the examination.

The IRS manual provides some guidance to examiners for identifying questionable transactions between U.S. corporations and related foreign corporations which may warrant detailed analysis. Part of this guidance is in a section entitled "Pointers to International Tax Avoidance" which contains several indicators of the possible existence of non-arm's length dealings. (See app. VI.) For example, two of the indicators are:

- Controlled foreign subsidiaries located in tax haven countries. A tax haven country is any country whose laws provide an escape from taxes on income which would otherwise be taxed in another country.
- Consolidated worldwide profits are higher than U.S. profits. This type of situation can be an indication that profits of the U.S. corporations are being diverted to a tax haven country.

Information needed for applying these pointers is obtained from the multinational corporation's tax return and supporting books and records. The identification of questionable transactions from these pointers is often more difficult than the equivalent process for many other code sections, because there is no account or amount shown on the tax return to indicate whether section 482 should become an issue. Therefore, the examiner must resort to the guidelines described above to identify transactions which may not be in compliance with the arm's length standard.

A functional analysis to show what the U.S. and the foreign corporation did to earn the income in question is difficult to perform

Once questionable transactions have been identified, examiners must begin the process of determining if an adjustment is needed and, if so, the amount. Where safe haven rules cannot be applied, examiners must obtain detailed information concerning the transactions in question. To determine whether the inter-corporate transactions were priced at arm's length, examiners must usually perform a functional analysis. A functional analysis involves a probe into exactly what the parent and its subsidiary actually did in relation to the income earned. A functional analysis is required because IRS believes that facts regarding comparable transactions must be analyzed to determine with accuracy just what should be measured.

According to IRS' manual, a functional analysis is based on the economic principle that in a business enterprise, or a group of enterprises, each function should earn its fair share of any resulting profits. When various functions are performed, the

enterprise that provides most of the effort, and/or the rare or unique functions, should earn most of the profit. IRS measures the relative importance of each function through functional analysis. The IRS manual requires the examiner to obtain sufficient data to answer questions such as: What was done? What significant functions were involved in doing it? Who performed each function, and what was the economic value of each function performed by each party? The manual specifies that normally the functional analysis begins with the organization which initiated the transaction and carries through until the transaction generated income from outside the controlled group.

To illustrate, if a parent sells goods to its foreign subsidiary, it is not enough in most instances to determine what price the corporation paid, the terms of payment, etc. In addition, the examiner must determine what the corporation did with the goods. For example, if the goods were resold by the foreign subsidiary, the manual states that the examiner should determine:

- a. Whether the corporation had a sales staff. If so, the examiner should determine how many and their compensation.
- b. Whether it was necessary to provide technical assistance to the foreign purchaser. If so, the examiner should determine who did it (the foreign corporation or the parent) and the kind of technical assistance provided.
- c. Whether the foreign corporation warehoused the goods or extended credit to its customers. If so, the examiner should determine the amount of capital needed to perform this function and/or the extent of bad debt experience.

IRS suggests that examiners prepare a checklist to document the results of the functional analysis. To prepare the checklist, examiners must list all the significant functions performed and then indicate who performed them, the U.S. corporation or the foreign subsidiary. (See app. VII for an example of a functional checklist.)

Once the significant functions and who performed them have been identified, the functions themselves must be analyzed. This analysis requires that examiners obtain other information to answer questions such as: Could anyone else perform the functions? How difficult are they? What skills are required? What equipment is used? According to IRS, it is critical that examiners focus on the relative importance of each function in terms of contribution to the total profit picture. Thus, a functional analysis requires data which may take considerable time to obtain and an analysis which will take still more time.

Once an examiner has completed a functional analysis, the next step is to search for a comparable uncontrolled price. The

IRS manual requires the examiner to begin by investigating the validity of the method used by the corporation in arriving at the price it used. For example, if the commission charged to a foreign corporation was based on commissions charged to independent parties, the independent transactions should be examined to determine if the commission can be used as a comparable. When a comparable price cannot be found from within the corporation's own controlled group the examiner must look to third party data. This step would require obtaining appropriate information from government sources, industrial organizations, investment services, and the private business sector.

Regardless of where comparables are obtained, the examiner must develop sufficient information concerning them to show that the transactions used are in fact comparable. This requires details concerning the terms at which the comparable transactions were handled and the circumstances surrounding the transactions, including a comparison between (1) functions performed by each party involved in the comparable transaction and (2) functions performed by the parent and foreign subsidiary in the questioned transaction.

IRS considers third party transactions comparable to the controlled transactions if the property and circumstances in the uncontrolled transactions are identical to those in the controlled transaction; or if they are so nearly identical that they have no effect on price or can be reflected by a reasonable number of adjustments to the uncontrolled sales. IRS also instructs its examiners that in some cases a single "best" comparable may not be found. Instead, there may be several independent transactions each of which differs from the questionable transaction in some significant way. However, considered together, the several independent transactions may be used to determine an arm's length price for the questionable transaction within a usable narrow range.

The IRS examination reports we reviewed provided some insight into the difficult and time-consuming work involved in performing a functional analysis and in analyzing arm's length transactions to determine adjustment amounts. The key aspects of a functional analysis and the development of a transfer price by an IRS economist can be illustrated by the following example.

Corporation A, a U.S. parent, bought electronic items from its foreign subsidiary. The IRS economist, as part of the functional analysis, researched the manufacturing process for the electronic products and found that it consisted of (1) silicon manufacturing which involved processing of high-purity silicon into slice form, (2) front end manufacturing which involved processing the slices to active elements with electronic functions built in, and (3) assembling and testing which involved assembling bars or chips into packages

and testing for varying environmental, functional, and electrical characteristics. According to the economist's report, the first two high-technology parts were performed by the U.S. parent. It was in the assembling and testing that the foreign subsidiary entered the manufacturing process. The functions performed by the foreign subsidiary included

- scribing the complete silicon slice,
- breaking the slice into chips,
- assembling good chips into finished devices with headers, lead frames, bonding material, lead wires, molding components and,
- testing finished devices and packaging.

On the basis of information developed through this analysis of the manufacturing process, the economist concluded that the foreign subsidiary should have been compensated for only assembly and test services. The economist then developed transfer prices for electronic items based on an analysis of what would be an appropriate amount (labor costs plus profit) to reimburse the foreign subsidiary for assembling and testing the items for the U.S. parent. The economist interviewed 10 independent contract assemblers (with facilities in foreign countries) to determine (1) the trade practices which prevailed when these contractors dealt with U.S. companies, and (2) the net profit margin which these contractors earned. The economist decided that the independent contract assemblers were functionally comparable to the foreign subsidiary's operation and that the independent net profit margins ranged from near zero to over 20 percent. Factors affecting the profit margins included the market conditions and the mix of simple and complex devices. One independent contract assembler provided the economist with its gross profit margin for 1 year for six major product categories and its income statement data. The economist converted the gross margin on sales percentages to net margin on cost percentages which then became the comparable profit rates used to compute the section 482 adjustment.

Some adjustments may not be made because the enforcement process is administratively difficult and time-consuming

In talking with examiners in the seven IRS districts we visited, we learned that they believe that some potential section 482 adjustments are not being developed. Examiners in three districts attributed this situation to both the difficulties in the

enforcement process and the time it takes to do the work. They stated that some examiners give higher priority to other international tax issues, such as foreign tax credits, because it is less difficult and less time-consuming to identify the additional tax. They added that section 482 work is a "high risk venture" where much audit work can result in little additional tax. They pointed out that because of this, some examiners hesitate to "go out on a limb" in attempting to develop an adjustment and focus only on cases of flagrant abuse. The examiners indicated that a section 482 adjustment might not be attempted because of the difficulty involved in reaching agreement on an arm's length price or on the basis for making the adjustment.

IRS was unable to provide us with data on the average length of time required to identify and develop a section 482 adjustment. One reason for this is that examiners work other international tax issues at the same time they are developing section 482 adjustments and sometimes work on several examinations simultaneously. Examiners also pointed out that the time needed to develop an adjustment can vary greatly depending on the type of adjustment being developed, the pricing method which must be used, and the cooperation of corporate officials.

A few examiners explained why the enforcement process takes so long. The primary reasons, according to the examiners, are that it takes time to study the corporation and/or its industry to become sufficiently knowledgeable to perform a functional analysis and to analyze comparable transactions, and that it takes time to obtain the substantial data and records that are needed from the corporation and other sources. These examiners also told us some of their experiences which can provide some insight into why the enforcement process is lengthy.

--Two examiners stated that to make an adjustment an examiner should (1) review the taxpayer's return including pertinent schedules, (2) review form 2952 for intercorporate pricing, (3) review prior IRS reports for section 482 adjustments (4) visit the library to study activities of the corporation through news articles, shareholder reports, etc., and (5) analyze the corporations' ability to make money by comparing profits to assets, payroll, sales, etc.

--One examiner said that if the corporation is not cooperative or does not have an adequate recordkeeping system, it could take over 1 year for the examiner to obtain sufficient information to determine whether an adjustment should be made.

--Another examiner said that obtaining access to corporate records to develop adjustments is a difficult task. He explained that questions on international tax issues are

the last ones answered because they have the potential to generate large amounts of tax dollars. He said it has been his experience that corporate officials answer only the questions asked and then with the least amount of data possible.

IRS examiners have also stated that they are unable to cover the universe of potential adjustments. During interviews in 1977 with House Committee on Ways and Means Oversight Subcommittee staff, IRS examiners said that when they are faced with numerous records of transactions, they generally rely on either a scanning of the records or the examination of a few of the largest dollar transactions over a 1- or 2-month period. It is obvious that with such techniques only a few transactions can be examined and that if transactions are not examined, potential adjustments cannot be identified.

Our statistics can be interpreted to lend credence to the examiners' comments. For example:

- Only 200 of the 519 multinational corporations in our data base had section 482 adjustments involving their foreign subsidiaries.
- The total profit (before taxes) of the corporations examined was \$43,513.8 million. However, the adjustments amounted to only \$277.5 million, a relatively small impact on corporate profit. The adjustments increased the profit of U.S. parents by 0.9 percent (\$277.5 of \$31,798.0 million) and reduced the profit of foreign subsidiaries by 2.4 percent (\$277.5 of \$11,715.8 million).
- The bulk of the total \$277.5 million was concentrated in only a few of the 403 total adjustments. Eleven of the 403 adjustments accounted for over one-half of the \$277.5 million.
- Adjustments involving the sale of tangible property, the category of intercorporate transaction where the largest amounts of revenue are at issue, were also concentrated. Thirty-five U.S. parents and 89 of their foreign subsidiaries experienced adjustments on tangible property sales of \$4.4 billion. The other 12,248 foreign subsidiaries of the 519 U.S. parents experienced no adjustments to a total of \$28.1 billion in intercorporate sales transactions.

Neither we nor IRS know how much noncompliance exists, nor how many more adjustments IRS should have made. However, given the difficulty inherent in administering section 482 through the current Treasury regulations, the examiners' statements, and the

statistics on the adjustments IRS made, we think it reasonable to conclude that the potential for greater enforcement exists.

The difficulty in making section 482 adjustments and the impact this difficulty has on enforcement was recognized as early as 1962 in a House report. 1/ The report stated that, in practice, the difficulty in determining a fair price under this code provision severely limits the usefulness of its power, especially when there are thousands of different transactions between a domestic corporation and its foreign subsidiaries.

A recent report documents the fact that section 482 adjustments continue to be a problem for all concerned. The study, dated January 12, 1981 and written by Richard Gordon, Special Counselor, International Taxation, was undertaken in response to a joint request by the Acting Commissioner of IRS, the Assistant Attorney General, and the Assistant Secretary of the Treasury for Tax Policy, and in response to congressional pressure upon IRS to take significant action against tax haven abuses. 2/ The study concluded that section 482 is one of the most important tools available to IRS for dealing with tax haven transactions but found that both IRS and taxpayers have had difficulties with the current section 482 regulations. The study recommended that the regulations be amended so as to ease some of the administrative burden placed on both taxpayers and the IRS and to achieve greater certainty in pricing international transactions.

CORPORATIONS, COURTS, TAX EXPERTS,
AND IRS OFFICIALS HAVE CRITICIZED
THE SECTION 482 REGULATIONS

Representatives of all groups affected by and knowledgeable about section 482 enforcement under the arm's length standard have voiced continuous and substantive criticism of the regulations. The criticisms focus on the fact that section 482 enforcement creates a large administrative burden and that the end result of a section 482 enforcement action is too often unpredictable and subjective.

1/U.S. Congress, House, Allocation of Income Between Related Foreign and Domestic Organizations, 87th Congress., 2nd sess., House Rept. 1447 (1962).

2/Richard A. Gordon, Tax Havens and Their Use by United States Taxpayers--An Overview (Washington: 1981).

A 1972 study by the Conference Board documented the views of corporate officials. 1/ Their principal objections to IRS' section 482 enforcement were that (1) the analytical approach to determining arm's length prices often leads to unreasonable results and (2) the examinations require extensive corporate expense and labor. The following are some specific criticisms of corporate officials as documented in the Conference Board report.

- Some officials believed the fundamental concept of arm's length dealing between related corporations is unrealistic. In a world of competition among multinational firms, they ask why the parent corporation should not favor its subsidiaries over unaffiliated corporations. The subsidiaries are expected to pay dividends while the unaffiliated corporations are not.
- Some officials described the examiner's determination of an arm's length price as "arbitrary." Some corporate tax executives stated that they did not know how the examiner got the figure proposed, and the examiner either could not or would not explain its derivation. In some of these cases, the corporation accepted the figure because the proposed adjustment was small.
- Some officials drew attention to the expense and labor involved in international examinations. The officials objected to what they considered an unnecessary load of paperwork. For example, the tax manager of one company declined to guess the cost of satisfying IRS examiners that international transactions do not violate section 482 regulations, although he believed the costs to be considerable. He said that he did not object because he considers the defense against IRS allocations a necessary function of his tax department. He did state, however, that the examiners raise many questions that take time and trouble to answer without being closely related to the examination.

A 1980 study report 2/ indicates that the concerns of corporate officials as included in the 1972 Conference Board Report are still concerns today. The study showed that arm's length prices have not been successfully applied to the extent anticipated by IRS when the regulations were approved. The study stated that, while the arm's length standard is based on the

1/Duerr, op. cit.

2/Burns, op. cit.

premise that a subsidiary is legally and economically separate from its parent corporation, only 41 percent of the corporations indicated that their organizations actually operate in this manner. In addition, the study showed that while the corporations were composed of numerous legally separate entities, 49 percent stated that they make most intercompany pricing decisions as though the organization was one economic unit. The study concluded that this difference in philosophy between the arm's length standard and multinational corporations is basic to the section 482 controversy. The 1980 study also concluded that (1) considerable uncertainty surrounds the implementation of section 482 through the regulations, and (2) section 482 adjustments are very costly. Although most corporate officials indicated in both studies that they accepted the arm's length premise, they expressed concern that the regulations were vague and confusing.

Several court decisions have also pointed out the administrative difficulty in section 482 adjustments. Specifically, a Court of Claims judge's decision in a 1978 case involving E. I. Du Pont De Nemours and Company stated the following:

"As evidenced by the magnitude of the record compiled in this case, the resolution by trial of a reallocation controversy under section 482 can be a very burdensome, time-consuming and obviously expensive process--especially if the stakes are high. A more manageable and expeditious means of resolution should be found. The evidence adduced in this case through Dr. Irving Plotkin, a skilled practitioner of the discipline of econometrics, strongly suggests that the promulgation of universally applicable safehaven criteria to facilitate the administration of section 482 may now be both entirely feasible and eminently proper." 1/

Another regulation problem--uncertainty--surfaced as a result of an Appeals Court decision in 1980 to reverse an earlier Tax Court ruling in a case involving the U.S. Steel Corporation. The Appeals Court accepted a price from a transaction which IRS and the Tax Court deemed not comparable because there were significant differences in the circumstances of the intercorporate transaction and the transaction used as a comparable. The decision stated the following:

"In very few industries are transactions truly comparable in the strict sense used by Judge Quealy. Every transaction in wheat, for example, is more or less the same, except for standard variations in amount, time of

1/E. I. Du Pont De Nemours and Company v. U.S., 608 F. 2nd. 445 (Ct. Cls. 1979).

delivery and place of delivery. But few products or services are as fungible as wheat. To say that Pittsburgh Steel was buying a service from Navios with one set of expectations about duration and risk, and [U.S.] Steel another, may be to recognize economic reality; but it is also to engraft a crippling degree of economic sophistication onto a badly drawn statute which--if 'comparable' is taken to mean 'identical,' as Judge Quealy would read it--would allow the taxpayer no safe harbor from the Commissioner's virtually unrestricted discretion to reallocate." 1/

One tax expert, in commenting on the judicial history of section 482, said that when readily comparable transactions have been available the decisions by the courts have been rather straightforward. However, when readily comparable transactions were not obtained the courts have had much greater difficulty in reaching a judgment. In such cases, the courts have generally required the corporation to show that its intercorporate transaction prices are correct rather than showing that IRS' allocation is erroneous.

IRS representatives have also expressed concerns about the subjectivity of section 482 adjustments. For example, they told us that:

--An examiner develops a price after studying all available data. However, the examiner has no assurance that the price developed is an arm's length price. The concept of an arm's length price is great in theory but in practice the price established is judgmental.

--An examiner finds it very difficult to obtain comparable uncontrolled prices. Approval from the third party is needed if a disclosure of the information is to be made. Generally third parties are reluctant to grant disclosure permission because of market competitiveness and the secrecy surrounding corporate activity.

Much of the criticism of section 482 enforcement, regardless of the source, seems to center on the incompatibility between the nature of multicorporate business activities and the arm's length standard. The nature of modern multicorporate business activities makes it difficult for IRS examiners to locate comparable uncontrolled prices on which to base adjustments.

1/U.S. Steel Corporation v. Commissioner of Internal Revenue, 617 F. 2d 942 (2nd Cir. 1980).

For example, the 1972 Conference Board report and other studies by tax experts gave several reasons why the comparable uncontrolled price method is seldom used in developing tangible property adjustments. These studies point out that many products, such as components and semifinished goods, are sold only to controlled subsidiaries because multinationals are often structured as an integrated production process. For such transactions, no open market equivalent exists. Other products, such as finished goods and raw materials, may be sold to both controlled and uncontrolled buyers, but the transactions may not be comparable because (1) different customers have different amounts of bargaining power, (2) customers have different objectives and are governed by different laws and regulations; and (3) customers receive different amounts and kinds of service.

In addition, the Conference Board report points out that the concept of a comparable uncontrolled price does not always correspond to intercorporate pricing practice. Only a few corporations base their intercorporate prices on comparable uncontrolled transactions. From questionnaires submitted by 512 corporations and 90 personal interviews, Conference Board researchers learned that corporate officials base prices for intercorporate transactions on long-range plans, not on prices for comparable uncontrolled transactions. Corporate officials more often ask the question "What are we earning this year and what will we earn 5 years from now?" rather than "What is the correct markup percentage on this component?"

In addition to long-range planning considerations, other factors may influence intercorporate prices. For example, a parent corporation may engage in a transaction with its foreign subsidiary at a low price in order to give the subsidiary a competitive advantage in the foreign market. Intercorporate pricing practices may also differ from uncontrolled transactions because a subsidiary is expected to pay dividends where an unrelated corporation is not. It is argued, moreover, that intercorporate prices are often not a matter of public knowledge and that even if a corporation wanted to base a transfer price on a comparable transaction, the corporation might have difficulty finding the necessary information.

Finally, some experts on section 482 enforcement argue that treating intercorporate transactions as separate taxable events conducted at arm's length can result in the creation of false profits or losses. They base this argument on the premise that a gain or loss cannot actually be realized until a transaction is made between a member of the controlled group and an independent party.

IRS AND TREASURY HAVE
CONSIDERED CHANGING THE
SECTION 482 REGULATIONS

In 1971 IRS statistics confirmed that there is often a lack of comparable uncontrolled transactions on which to base arm's length prices for section 482 adjustments. In connection with these statistics, the Deputy Assistant Secretary of the Treasury, in a June 1971 memorandum, made the following comments:

"We think it is time to concede that in the absence of comparable third party transactions plainly analogous to the transaction being examined, the most we can hope for is the assurance of a reasonable return to the U.S. taxpayer for its cost and effort in producing or marketing the product, as the case may be. In cases where such third-party comparables are not readily available, a precisely correct determination of the hypothetical arm's length price is impossible. Under the best of circumstances the answer finally settled upon can only be a rough and unproven estimate of what would have been the terms of the transaction if the parties had not been related."

During 1971 Treasury and IRS considered, but did not implement, several regulation changes involving the sale of tangible property transactions. The changes were considered to make section 482 enforcement using the arm's length standard less difficult and more fair. According to the Deputy Assistant Secretary, consideration of the changes was needed because of the persistent criticism of the regulations by corporate officials, professional groups, corporate associations, and trends in court cases. The proposed changes were circulated to Treasury, IRS, and the Department of Justice for comment but no action was taken. The proposed changes included:

- Reducing uncertainties encountered by multinational corporations in determining whether an intercorporate transaction would be subject to an adjustment by revising the regulations to extend the use of safe haven pricing.
- Revising the priorities given to various methods of determining an arm's length price. Specifically, only prices actually obtained from comparable uncontrolled transactions involving the corporation in question would be given priority. The search for an arm's length price would thus be limited to within the corporation.
- Specifying in the regulations how the examiner should arrive at an arm's length price when using the fourth ("any other") method.

A 1978 closing memorandum noted that several of the comments received on the proposed changes indicated that large businesses would benefit while small businesses would be adversely affected. Other comments indicated an overall satisfaction with the existing regulations. IRS' Economic Advisory Group commented that the proposed changes would condone the non-arm's length pricing of intercorporate transactions and significantly reduce the revenue IRS achieves from section 482 enforcement. Apparently for these reasons, no further action was taken.

TREASURY SHOULD STUDY THE
FEASIBILITY OF IMPROVING THE
SECTION 482 REGULATIONS

The regulation changes considered by Treasury and IRS were drafted in 1971. Since then, experts in the field of section 482 enforcement, independent studies such as the 1972 Conference Board Study, court opinions, and corporate officials have continued to express substantive criticisms of the uncertainty and administrative burden created by the section 482 regulations. The validity of the arm's length premise has been questioned and specific changes to the regulations have been suggested.

We believe the problems experienced in implementing the section 482 regulations are sufficiently serious to be addressed. To do this, Treasury should, as a first step, undertake a study to evaluate the feasibility of the suggested changes to section 482 as well as to identify additional ways to allocate income.

Corporate officials and
experts have suggested
ways to make section 482
adjustments more certain

Some officials have suggested changes to the regulations which would provide greater certainty before an IRS examination and would thus allow them to better plan their financial strategy. The suggestion offered most frequently by corporate officials was that Treasury identify some means of establishing a range of prices within which U.S. corporations could operate without fear of later adjustments. Some executives have suggested that safe haven ranges be worked out on an industry or product-line basis. Others have suggested that some division of profit between the U.S. corporation and its foreign subsidiaries be set as a reasonable yardstick. In either case, the officials believed the safe haven range would eliminate the uncertainty concerning the pricing of intercorporate transactions and reduce unproductive administrative costs to both the corporations and IRS. Underlying the comments of many officials who favored a safe haven range for pricing is the conviction that such a range, however difficult to establish, would be an improvement over the present system of determining arm's length prices. The expanded

use of safe havens would allow corporate officials a degree of certainty they now lack as to the tax consequences of their pricing of intercorporate transactions. Those corporations whose market situation required pricing structures that fell outside the safe haven range would be no worse off than they are today. They would still have to bear the burden of proving that their prices were justified.

Tax experts, in articles based on court cases, studies, and other sources of information, have also stated that regulation changes are needed. Their suggestions have generally revolved around the use of safe havens and profit splits as acceptable methods to use in determining section 482 income allocations. For example, corporate officials suggested in the Burns study that Treasury expand the use of safe haven rules, establish acceptable profit splits or a minimum percentage of the profit to be included in U.S. income, and adopt formulas such as those available to Domestic International Sales Corporations (DISCs) for calculating transfer prices.

In connection with the above comments, IRS has established centralized pricing units for a few commodities (see p. 6). These units control the price that must be used by international examiners in making section 482 adjustments. The price established by the pricing units is known by both corporate officials and IRS examiners. According to IRS, the pricing units were established to better use limited resources and to provide for uniform and consistent treatment of common issues among corporate taxpayers.

Other experts and studies have suggested using formula apportionment, where applicable, instead of the arm's length standard

Other experts and studies have questioned the validity of the premise underlying the arm's length standard that a parent corporation and its subsidiary are in all instances operating as two separate corporations. These experts and studies have argued that when a multinational parent's operations are sufficiently integrated with its foreign subsidiaries, formula apportionment, as used by the States, is a more appropriate method to use in allocating the income. In these situations, they believe the arm's length standard is fundamentally flawed because it is not consistent with the economic reality of the operations of the related corporate group.

In contrast to the arm's length standard, formula apportionment under the unitary method views controlled corporations which conduct integrated business operations as a single unit or business for tax purposes. The premise is that these controlled corporations are coordinated by a central management policy and

organizational structure which seeks to maximize profits. It is argued that since all of the controlled corporations which are involved in the integrated operations are considered to be part of the same unitary business, intercorporate transactions cannot produce a real economic gain or loss. Thus, profit or loss is determined solely by transactions with unrelated businesses, the same as for a "truly" independent corporation.

Under formula apportionment, a formula is used to apportion the income between the commonly controlled corporations. The formula represents the relationship of the individual corporation's activities to the total activities for the controlled group. The factors most discussed for use in the formula are the ones used by the States to tax multistate and multinational manufacturing and mercantile corporations. All 45 States which tax corporate income use some combination of property, payroll, and sales as formula factors. The apportioning of the income by such a formula is merely a device for the division of the income earned. The formula does not impose any tax on the income.

Formula apportionment might eliminate
some problems associated with using
the arm's length standard

Advocates of formula apportionment indicate that this method is not only more appropriate to use in situations involving integrated operations among controlled corporations but could actually eliminate some of the problems associated with using the arm's length standard. Advocates claim that this has been demonstrated by the States, particularly California.

They explain that the States use formula apportionment primarily because of (1) the extensive potential for tax avoidance through non-arm's length transactions between controlled corporations, (2) the need to substantially increase the number of their auditors to address this potential through the arm's length standard, and (3) the belief that enforcement through the arm's length standard is not working well at the Federal level. They also point out that formula apportionment eliminates the arm's length assumptions that

- an arm's length market price can always be established;
- general overhead and administrative expenses can be fairly allocated among the commonly controlled corporations involved in the integrated operations; and that
- it is possible to determine the proper amount of profit allocation to different functions such as manufacturing and selling.

In addition, advocates claim formula apportionment would eliminate the complaints of multinational corporations (1) that they do not know at the time transactions take place whether they will result in an IRS allocation and (2) that they are operating under regulations characterized as vague, confusing, and impossible to interpret in terms of international business.

Formula apportionment would present different problems

Critics of formula apportionment raise several objections to its use. The more important criticisms include (1) the difficulty in defining those controlled corporations which should be included in the unitary business operations of the multinational corporations; (2) the lack of comparability of the factors used in the formula from one country to another; (3) the administrative burden associated with obtaining the data needed to use formula apportionment; and, (4) the fact that the arm's length standard has worldwide acceptance.

Advocates acknowledge that the above criticisms of formula apportionment have validity. However, they also believe that these problems have solutions. For example, they recognize that a corporation would not know in advance of an IRS examination whether or not it would be considered unitary unless the definition of unitary is uniformly applied and administered. However, they also cite one State which uses formula apportionment under the unitary concept as having initiated an advance ruling program to eliminate this problem.

The advocates also acknowledge that there may be some distortion in the factors used in the formula from one country to another. However, they believe that it is possible to eliminate the distortion in the factors--to a great extent--through the use of comparability tables. Concerning the administrative burden, the advocates indicate that some U.S. multinational corporations now prepare sophisticated financial analyses for U.S. purposes and that this information could be used in applying the apportionment formulas. As such, formula apportionment should not place any greater burden on the administrative resources of the corporations than the arm's length standard. They also believe that formula apportionment would place much less of a burden on IRS' resources than does section 482 enforcement under the arm's length standard. They indicate that this is one of the reasons why the States have adopted this method.

CONCLUSIONS

Making income adjustments using the arm's length standard has posed administrative burdens on both IRS and corporate taxpayers. Because of the structure of the modern business world,

IRS can seldom find an arm's length price on which to base adjustments but must instead construct a price. As a result, corporate taxpayers cannot be certain how income on intercorporate transactions that cross national borders will be adjusted and the enforcement process is difficult and time-consuming for both IRS and taxpayers.

Parties affected by and knowledgeable about arm's length adjustments--officials at IRS and Treasury, corporate taxpayers, courts, and experts in the field--have voiced substantive and on-going criticisms of the section 482 regulations. Treasury's decision in the early 1970s to consider several regulation changes indicates that it recognized the validity of the criticism at that time. Given the continued flow of criticism since then and the continued growth in the number and complexity of intercorporate transactions as compared to IRS' limited resources, it seems to us that the need is even greater now than it was a decade ago for Treasury to consider revising the regulations.

Experts have suggested that changing the regulations to expand the use of the safe haven concept would bring greater certainty to the enforcement process. Other experts have suggested that using the formula apportionment method, when appropriate, would eliminate the need to search for an arm's length price, reduce administrative burden, and make section 482 enforcement more certain. The States, whose examination resources are even more limited than IRS', use formula apportionment for these reasons.

A major objection to the use of formula apportionment across national borders is that tax treaties between the U.S. and other nations specify the arm's length standard for adjusting corporate income. For the U.S. to adopt a different method could result in multinational corporations incurring double taxation. We recognize the significance of this problem. However, we also believe that as a world leader and international policy-setter, the U.S. should not be hesitant to take the lead in searching for better ways to administer the tax consequences of intercorporate transactions that cross national boundaries.

In this regard, Treasury should be the focal point for a study to identify ways to improve section 482 enforcement. The need for such a study will become even more urgent if IRS' measure shows extensive noncompliance. After Treasury has completed this study, it should be able to make an informed decision as to whether and how it should change the section 482 regulations.

RECOMMENDATION TO THE SECRETARY
OF THE TREASURY

We recommend that the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under section 482, including formula apportionment,

which would lessen the present uncertainty and administrative burden created by the existing regulations.

AGENCY COMMENTS AND
OUR EVALUATION

While IRS and Treasury recognized that section 482 enforcement procedures present problems, both agencies expressed disagreement with our recommendation that Treasury undertake a study of the regulations. In so doing, both agencies, we believe, minimized the seriousness of the difficulties which section 482 enforcement has presented and continues to present all affected parties. As we noted in our report, uncertainty as well as the administrative difficulties and burden on all parties affected by section 482 enforcement have been documented in all previous studies on the subject, the most recent being a January 1981 study undertaken at the joint request of the Acting Commissioner of IRS, the Assistant Attorney General, and the Assistant Secretary of the Treasury for Tax Policy.

In addition, both Treasury and IRS expressed serious reservations about our statistics and seemed to think that they presented a misleading picture of section 482 enforcement. Both agencies seemed to believe we understated the extent of present section 482 enforcement and overstated the administrative difficulties. We incorporated into the report more specific recognition that IRS made some section 482 adjustments which we excluded from our sample. We also clarified the explanation of our scope and our rationale for excluding certain adjustments. We believe our statistics accurately reflect the pertinent data available and, together with the other evidence presented in the report, convincingly show that the problems inherent in enforcing section 482 are substantial.

IRS' and Treasury's Reservations
Concerning the Recommended Treasury Study

IRS seemed to interpret our report as recommending that Treasury reconsider the fundamental principle of the arm's length standard. In this regard IRS pointed out that Treasury was in the process of revising the regulations and stated that, specifically, Treasury was studying ways to amend the regulations relating to a safe haven rule for the sale of tangible property and would publish proposed regulation changes shortly. IRS thought that Treasury's approach of revising parts of the regulations was better than such wholesale reworking of the regulations as IRS understood us to have recommended. In addition, IRS did not think that it had enough experience to participate in a reconsideration of the arm's length standard.

We did not in fact recommend a wholesale reworking on a one-time basis but simply that Treasury study the regulations. It was our intent that Treasury would take whatever course is indicated by the study results. Moreover, we believe that IRS' 12 years of experience in this area should enable it to participate effectively in such a study.

Treasury stated that it disagreed with our recommendation that it consider adopting formula apportionment as a substitute for the arm's length standard. However, we did not make such a recommendation. What we recommended was that, as part of its study of section 482 enforcement procedures, Treasury should consider all alternatives, of which formula apportionment is but one.

Treasury objected to the use of formula apportionment on several grounds. Treasury stated that formula apportionment has little merit because a corporation could have an increased tax burden as a result of its subsidiaries becoming more profitable. Thus, according to Treasury, formula apportionment does not attempt to achieve the statutory objective of correctly reflecting a taxpayer's income. Treasury also asked whether formula apportionment should be used even when comparable uncontrolled prices are available.

Treasury's response suggests to us that Treasury may have thought we recommended the use of formula apportionment to make income adjustments in all cases. In contrast to the arm's length standard, formula apportionment under the unitary method views controlled corporations which conduct integrated business operations as a single unit or business for tax purposes. The formula is used to apportion the income between taxing jurisdictions. Since the formula sources the income of the controlled group to each taxing jurisdiction, arm's length price determinations for individual transactions are not needed. However, it is important to keep in mind that formulas are applied only to unitary businesses. If the controlled corporations are not considered to be unitary in their business operations, then any transactions that need to be adjusted would be adjusted using the arm's length standard. Thus, if, after its study, Treasury were to decide to use formula apportionment, it would simply have an additional enforcement tool available to complement the arm's length approach.

Treasury further stated that we minimized the administrative difficulties that would result from the use of formula apportionment. As an example, Treasury cited the practical problems involved in deciding whether or not a corporation should be considered unitary. It was not our intent to minimize the administrative difficulties nor to emphasize the benefits of formula apportionment. It was our intent, however, to point out that the approach is characterized both by benefits and difficulties and to give examples of each (see pp. 50 to 52).

We included a discussion of formula apportionment in our report because tax experts and studies we encountered in our review cited formula apportionment as one alternative that might lessen administrative burden and uncertainty. There is, however, no empirical evidence available to prove or disprove the feasibility of implementing the approach at the Federal level. It was our intent that the Treasury study we recommended would develop such empirical evidence.

Treasury also stated that formula apportionment is not widely used by the States in a multicorporate context. Treasury also said that some States which apply the formulas worldwide are considering abandoning them. However, Treasury gave no support for these statements. Evidence available to us does not support Treasury's contention. In response to a questionnaire we sent to each of the 45 States with a corporate income tax, 26 States replied that they use formula apportionment under the unitary method in cases involving multicorporate entities (affiliated corporations) located within the United States while 11 States replied that they apply formula apportionment worldwide. None of the States responding to the questionnaire indicated an intent to abandon formula apportionment. To our knowledge, the only change that a State is currently contemplating to restrict rather than expand the use of formula apportionment is in the form of legislation being considered in California. That legislation would restrict the use of formula apportionment only to the extent of excluding foreign parents of U.S. corporations in certain types of industries.

Both Treasury and IRS cited a 1979 report by the Organization for Economic Cooperation and Development in support of their reservations about the use of formula apportionment. IRS suggested we state in our report that OECD has rejected the use of formula apportionment because it presents difficulties for taxpayers. Treasury suggested we consider the OECD criticism of formula apportionment as inconsistent with the provisions of current U.S. tax treaties. We did consider the OECD report during our review. We chose not to discuss the OECD comments on formula apportionment because they were not supported by empirical data to the same extent as other studies which we did include. The OECD statements that formula apportionment presents difficulties for taxpayers were based on comments submitted by its member countries, and the OECD report does not present empirical data to support its conclusions. The OECD report did, however, correctly point out that use of alternatives to the arm's length standard is incompatible with the OECD Model Double Taxation Convention. Again, we did not recommend that Treasury should implement formula apportionment much less undertake any such implementation unilaterally. If a Treasury study were to show through empirical data that formula apportionment did indeed have merit, Treasury would still need to give considerable thought to the best approach of obtaining international

support for change and implementation of the concept. Alternatives might include taking a leadership role appropriate to a world power such as the U.S. and, in this leadership role, educating other countries to the benefits of formula apportionment or other techniques providing for effective implementation.

IRS and Treasury Criticism
of GAO Statistics

Both IRS and Treasury seemed to think that our statistics presented a misleading and, in some cases, inaccurate picture of section 482 enforcement, a picture which overstated the difficulties involved. We believe our statistics accurately reflect the data available to us and convincingly show that the difficulties involved in enforcing section 482 are both real and substantial.

IRS questioned whether we had included all relevant section 482 adjustments in our statistics. Specifically, IRS thought we erroneously excluded \$330 million in adjustments from our sample. We excluded the \$330 million because these adjustments did not involve a foreign subsidiary and, thus, did not in a real sense cross national boundaries. We focused our review on adjusted transactions involving foreign subsidiaries because we believe that it is in adjustments made to such transactions that the real workability and effectiveness of the arm's length standard must be measured.

IRS also noted that our statistics did not include any cases from the oil industry. IRS assumed that this was because such cases were not closed during the period covered by our sample. IRS was correct in this assumption. Since the data available to us did not include cases involving the oil industry, we cannot address IRS's statement that such adjustments exceed \$600 million annually.

IRS also thought we had understated the total number of adjustments which were based on a comparable uncontrolled price. IRS said we should have taken into account that 240 of the 403 adjustments were attributable to situations where the use of safe haven pricing rules was mandatory. Had we excluded these 240 transactions from the total of 403 adjustments, we would have reported that 7 percent, not 3 percent, of IRS' section 482 adjustments were based on comparable uncontrolled prices. We did not exclude these 240 adjustments based on safe haven rules because our purpose was to show how many of the total section 482 adjustments in our sample were based on comparable uncontrolled prices. Safe haven prices by definition are not comparable uncontrolled prices. Rather, they are prices established by IRS and Treasury to be used in specific situations. IRS has recognized that safe haven prices are not comparable uncontrolled prices and will permit a corporation to use a comparable

uncontrolled price instead of a safe haven price if such a comparable uncontrolled price can be supported. Thus, in terms of our purpose we would have been remiss had we excluded the safe haven adjustments from our computations.

IRS added that its current data (examinations completed during fiscal year 1980) showed that 20 percent of its recommended section 482 adjustments were based on arm's length prices using the comparable uncontrolled method. We did not review the data IRS cited and thus do not know whether it is readily comparable with our results. Even so, using comparable uncontrolled prices in only 20 percent of the adjustments is not, in our opinion, an indicator of substantial success.

Treasury thought we concluded that the present regulations are seriously defective solely because the comparable uncontrolled price method is only infrequently used. Treasury said we failed to recognize that other methods outlined in the regulations are only alternatives for arriving at an arm's length price and not departures from that principle. We did distinguish between adjustments based on the identification of a comparable uncontrolled price and adjustments based on an estimated price constructed by an IRS examiner using one of the alternative methods permitted when a comparable uncontrolled price cannot be easily identified (see pp. 28 to 29). We did so because we do not believe that an estimated price is the same as a comparable uncontrolled price. Moreover, our conclusion that section 482 enforcement under the current regulations is uncertain and administratively burdensome is not based solely on our statistical analysis of the sample. Our review of the recent relevant literature by experts in the field of section 482 enforcement also led us to this conclusion, a conclusion to which our statistical analysis lends support.

Treasury further pointed out that we did not identify any specific indications that uncontrolled prices are not used in cases of intercompany pricing which do not lead to an IRS adjustment. We made no statement concerning such cases because this type of information is not available. Neither Treasury nor IRS has developed methods to obtain the data needed to measure the extent of noncompliance that exists within the universe of multinational corporations. IRS, however, agreed with our recommendation that it develop such data (see p. 26). Treasury's position seems to be that, if the transaction was not adjusted, it met the arm's length standard. We do not think this position is realistic when analyzed in light of the information we were able to obtain. Although the information available to us provided only an indication that increased potential for adjustment exists, we believe this possibility should not be ignored. IRS examiners told us that only a few transactions can be examined and if transactions are not examined, potential adjustments cannot be identified. They also stated that some examiners give

higher priority to other international tax issues because other issues are less difficult and less time-consuming. Our statistics can be interpreted to lend credence to the examiners' statements (see p. 41).

Treasury further questioned our conclusion that difficulties exist in applying the section 482 regulations by stating that our statistical analysis was misleading or unpersuasive. Specifically, Treasury objected to our statistic that only 200 of the 519 corporations experienced adjustments because, according to Treasury, these data are subject to various interpretations and do not necessarily reflect difficulties with applying the regulations. Treasury also questioned our comparison between the \$277.5 million in section 482 adjustments and the \$43.5 billion total income of the examined firms. Treasury stated that a significant portion of the income may be unrelated to transactions between affiliates. To be sure, the fact that only 200 of the 519 corporations experienced adjustments could be interpreted differently, although Treasury did not make clear how this might be done. We made our interpretation in the total context of information on section 482 enforcement available to us, including examiners' statements that difficulties in section 482 enforcement may cause some adjustments to be missed, and such statistics as could be developed. We believe that, taken in a total context, the evidence suggests that a greater potential for section 482 adjustments does indeed exist.

Finally, IRS felt that we understated the frequency with which comparable uncontrolled prices are used in making tangible property adjustments, the category of adjustments where the largest amounts of revenue are involved. IRS stated that its more current data (examinations completed during fiscal year 1980 and 6 months of fiscal year 1981) showed that 50 percent of these adjustments were made using comparable uncontrolled prices (as opposed to 15 percent in our data base). IRS added that the other studies of section 482 (see p. 33) which showed that only 21 to 28 percent of tangible property adjustments were made using comparable uncontrolled prices did not support our conclusion.

We did not review IRS' current data and thus do not know if it is readily comparable with that in our sample. However, we do believe the other studies of section 482 enforcement support our conclusion that comparable uncontrolled prices are not frequently used in making tangible property adjustments. The other studies, completed during 1972, 1973, and 1980 showed that comparable uncontrolled prices were used in 28, 21, and 24 percent of tangible property adjustments respectively. The higher percentages shown by the three studies and by IRS' current data may be due to the fact that those statistics include adjustments involving DISCs, Western Hemisphere Trade Corporations (WHTCs), and U.S. possession

corporations. Such adjustments were not included in our statistics because the transactions did not involve a foreign subsidiary. These studies also concluded that comparable uncontrolled prices were difficult to identify and were thus not frequently used in making tangible property adjustments. Moreover, even if IRS' most current data indicating a substantial increase in the use of arm's length prices for tangible property adjustments over that shown by other studies is readily comparable with our sample transactions, administrative burden and uncertainty for all affected parties would still exist in one-half of all tangible property adjustments.

CHAPTER 4

SCOPE OF REVIEW

The House Committee on Ways and Means, in a May 3, 1978, letter, asked us to study IRS' administration of section 482 of the Internal Revenue Code when auditing multinational corporations. Specifically, the Committee asked us to determine whether IRS was experiencing problems using the arm's length standard in allocating income among commonly controlled corporations. If so, the Committee wanted to know whether the cause was poor management, a flawed conceptual approach, or a combination of both.

We studied IRS' administration of section 482 by reviewing the results of its examinations of large multinational corporations included in the CEP. At the time of our review, the corporations included in this program each had assets of \$250 million or more. Generally, IRS examines the returns of these corporations for each tax year. We used multinational corporations in the CEP because

--they account for about 90 percent of the dollar volume of transactions between all U.S. parents and foreign subsidiaries, and

--they account for about 70 percent of IRS' total effort in examining international tax issues.

As of March 31, 1979, the CEP encompassed 637 multinational corporations, 22 of which were controlled by foreign parents. IRS' Statistics Division provided us with information on the intercorporate transactions each of the remaining 615 U.S. corporations had with their foreign subsidiaries during fiscal year 1975 as reported to IRS on form 2952. The 22 corporations controlled by foreign parents did not submit form 2952.

To identify a cutoff point which would give us the most usable and current examination results, we reviewed various IRS records and statistics. These indicated that IRS' examinations of returns filed for the tax year ending between July 1, 1974, and June 30, 1975, were mostly being completed during calendar years 1978 and 1979 about the time we were beginning our work. Thus, we asked IRS to provide us with its examination reports on the tax returns filed by the 637 corporations in the CEP for those tax years. If the examination reports for the tax returns filed between July 1, 1974, and June 30, 1975, were not completed by September 30, 1979, we asked that IRS provide us with its examination reports for that corporation's tax returns filed between July 1, 1973, and June 30, 1974. If an examination report had not been completed for either period, we asked that no information be sent to us.

Requesting information from examination reports for an alternate year was suggested by IRS officials to ensure that we would obtain a sufficiently large data base. To the extent that we included information from examination reports for an alternate year, a portion of IRS' recommended section 482 adjustments were for 1 tax year earlier than the data IRS' Statistics Division provided us from the filed forms 2952. We used the data from the forms 2952 only to show the growth in intercorporate business and to provide some indications of the potential for section 482 adjustments. Thus, the nonuniformity between the years covered by the examination reports and the forms 2952 does not affect our conclusions or recommendations.

Specifically, we asked IRS to provide us with the international examiners' report (IERs) and selected sections from revenue agents' reports (RARs) prepared on examinations of the 637 multinational corporations. The IER is usually completed first and information from it is then incorporated in the RAR. We ultimately received one or both reports on 519 of the 637 corporations. According to IRS, neither the IER nor the RAR were completed by September 30, 1979, for the remaining 118 corporations. Thus, we received reports on examinations of tax returns filed for the tax year ending between July 1, 1974, and June 30, 1975, for 390 of the 519 corporations. For the remaining 129 corporations, the reports we received pertained to returns filed for tax years ending between July 1, 1973, and June 30, 1974.

Our statistics may portray a liberal picture of the income adjustments which will ultimately result from IRS' section 482 enforcement activities. Because of our decision to analyze the most current IRS examinations, we included in our statistics adjustments recommended in 108 IERs even though the RARs for these examinations were not completed by the September 30, 1979, cutoff. Since information from IERs is occasionally revised before being incorporated into the RAR, these recommended adjustments may be subject to change at a later point in the tax return closing process. In addition, adjustment information from RARs is subject to revision based on (1) decisions made by IRS appeals officers and courts or (2) negotiations between IRS and foreign tax authorities under income tax treaties. However, according to IRS, the recommended amount of the adjustment is nearly always revised downward rather than being increased.

The statistics we developed from the reports received for the 519 corporations showed that IRS recommended 403 section 482 adjustments totaling \$277.5 million. These adjustments involved 200 parent corporations and their foreign subsidiaries. We did not develop statistics on the section 482 adjustments IRS made to

transactions between the 519 corporations and WHTCs, 1/ DISCs, 2/ and/or U.S. possession corporations. 3/ These adjustments totaled \$330 million and involved 235 corporations. We excluded these adjustments because the transactions did not involve a foreign subsidiary and, therefore, did not in a real sense cross national boundaries.

We focused our work on transactions that involved foreign subsidiaries because it is in this area that the real workability of the arm's length standard must be measured and the area where arm's length must work well, if it is to be effective. As explained in chapter 1, this area has been growing rapidly since the Second World War and should continue to grow as multinational corporations expand their markets in foreign countries. In addition, DISCs are corporations located in the United States which primarily perform a sales function. We were told by some examiners that difficulties associated with making adjustments involving foreign subsidiaries are not always encountered when adjusting the income between a DISC and its U.S. parent. In 1976, WHTCs were phased out. A review of adjustments involving these corporations would not be a valid test to indicate how effective the arm's length standard may be in adjusting the income of other corporations in future years.

In addition to developing statistics on the nature and extent of adjustments made by IRS in enforcing section 482 for the corporations in our sample, we also developed statistics, through a review of the examination reports, on the pricing method used by IRS examiners in making the adjustments. The reports either stated the method the examiner had used or the method used was obvious based on the examiner's description of what had been done. We were, however, unable to determine the method used from information in the reports for 25 adjustments.

As part of our study, we also examined IRS policies, procedures, and practices for enforcing section 482 using the arm's length standard. We visited the Department of Commerce and IRS' Statistics Division to obtain data on the growth of multinational corporations and magnitude of their intercorporate transactions.

1/These corporations conduct all their business outside the U.S. but within the Western Hemisphere. The corporations qualify for a special deduction reducing their taxable income.

2/These corporations are allowed to defer taxation on a portion of the income earned through export sales.

3/These corporations, which operate in U.S. possessions, can exclude up to 100 percent of their income from Federal taxation.

We reviewed (1) studies prepared by various organizations and tax experts on IRS' enforcement of section 482, (2) papers and articles on section 482 prepared by recognized authorities on the subject such as prior and current Federal officials, lawyers, practitioners, and members of the academic world, and (3) selected court cases.

In addition, we reviewed international examiners' audit plans and workpapers and discussed section 482 enforcement with a total of 82 examiners, case managers, group managers, appeals officers and other IRS representatives in the Chicago, Cleveland, Detroit, Manhattan, Newark, Los Angeles, and San Francisco districts. We chose these districts because they encompassed the tax returns of 67 percent of the multinational corporations in our data base.

At the IRS national office, we discussed section 482 enforcement with staff economists and officials of the Examination Division, the Office of the Deputy Chief Counsel (Technical), Office of Internal Operations, and the Appeals Division. We also discussed studies pertaining to the arm's length standard and to apportionment formulas with officials from the Department of the Treasury.

We did not contact corporate officials during our study. Comments from corporate officials have been considered and published in other studies, one as current as May 1980. We used the results of these studies in our review. (See pp. 33 and 43.)

SUMMARY OF RULES FOR
ADJUSTMENTS INVOLVING LOANS AND ADVANCES,
SERVICES, AND USE OF TANGIBLE PROPERTY

To determine the amount of section 482 adjustments involving (1) loans and advances, (2) performance of services for another, and (3) use of tangible property (rent) the regulations permit two types of prices--an arm's length price and a safe haven price.

Loans and advances

The regulations allow IRS to impute or adjust interest income to related non-arm's length intercorporate transactions involving loans, advances, and other types of indebtedness. The regulations specify that in adjusting some types of transactions, the examiner must identify or establish an arm's length rate, while in others the examiner can use a safe haven interest rate. The arm's length rate is used when the lender is in the business of making loans to unrelated businesses of the same general type as the loan in question. The arm's length rate is the rate of interest that would have been charged at the time the indebtedness arose in transactions between unrelated businesses. All relevant factors must be taken into account in establishing the arm's length rate.

When the lender is not in the business of making loans or advances of the same general type as the loans or advances made to corporations within the controlled group, then the safe haven rate applies. The safe haven rate is the rate of interest actually charged so long as it is at least 11 percent but not greater than 13 percent. If the lender did not charge any interest or charged a rate which does not meet the 11 to 13 percent safe haven standard, then adjustment is based on the safe haven rate of 12 percent per annum simple interest. If the corporation is able to establish a more appropriate rate, then that rate is considered the arm's length rate.

Services

When a member of a controlled group renders services for the benefit of another member of the group at no charge or at a price other than an arm's length price, the regulations again permit the examiner to base the adjustment on either an arm's length price or a safe haven price. The price which is used depends on whether the services rendered are an integral part of the trade or business of either the member rendering the service or the one receiving the service.

When the service is an integral part of the trade or business of either the renderer or the recipient of the service, the examiner must identify or establish an arm's length price. The price is the amount that is charged (or would have been charged) for the same or similar services in transactions with or between unrelated businesses under similar circumstances. The regulations consider services to be an integral part of a trade or business when:

1. Either the renderer of the service or the member receiving the services is engaged in the trade or business of rendering services to unrelated business.
2. The renderer provides services to one or more related corporations as one of its principal activities.
3. The renderer is peculiarly capable of rendering the service and such services are a principal element in the operation of the recipient.
4. The recipient has received the benefit of a substantial amount of services from one or more related corporations during its taxable year.

When the services are not an integral part of the trade or business of the renderer or the recipient, the safe haven price is the full costs directly or indirectly related to the service. Direct costs are those which can be identified with the service. These include such expense items as compensation, bonuses, travel expenses of employees rendering the service, and cost of materials directly consumed in providing the service. Indirect costs cannot be specifically identified with any specific activity or service but relate to the direct cost of the service. Indirect costs include such items as utilities, rent, and supervisory and clerical compensation.

Use of tangible property (rent)

As in the case of loans and advances and services, the regulations permit two types of prices on which adjustments can be based: an arm's length price based on transactions between unrelated businesses, or a safe haven price. When the owner or user is engaged in the business of renting property similar to that leased to the related corporation, the arm's length price is the amount that would have been charged in transactions between unrelated businesses under similar circumstances. When neither the owner or the user is engaged in the business of renting similar property, the safe haven price is the sum of the expenses paid or accrued by the owner or lessee, the depreciation, and percentage

of the depreciable basis of the property. However, if the corporation can establish by reference to third-party transactions a more appropriate price, then that charge will be the arm's length price.

The regulations provide that a safe haven price is the sum of the following:

1. The amount of depreciation is arrived at by dividing the depreciable basis of the property by its total useful life in the hands of the owner. The depreciable basis is the original cost or other basis of the property, adjusted by capital items and reduced by estimated salvage but not reduced for exhaustion, wear and tear, and obsolescence. The total useful life, depreciable basis, and salvage value shall be estimated based on the facts and circumstances known to exist at the time of the lease. However, if capital improvements were made to the property after the time of the lease or rental, the basis is adjusted when such improvements become substantial. For this purpose, improvements will be considered substantial when the total adjustments exceed 25 percent of the adjusted basis of the property.
2. Three percent of the depreciable basis of the property.
3. Expenses directly and indirectly connected with the property that are paid or accrued by the owner. The expenses include taxes on the property, repairs, maintenance, utilities, and management expenses. Interest expense, however, is not to be included.
4. Expenses in connection with the possession, use or occupancy by the user or lessee paid or accrued by the owner or lessor during the taxable year. These include expenses in connection with the transfer of the property or other similar expenses.

The regulations provide that capital expenditures during any taxable year in connection with the use of the property by the user-lessee are considered expenses paid or incurred by the owner to the extent that they may be properly amortized for the taxable year.

If the property was used by more than one party (whether related or unrelated) during the taxable year, then only a portion of the sum of the expenses is to be taken into account with respect to each user. The amount to be taken into account is

the proportion of the sum which the number of days the property was used by the user-lessee bears to the number of days it was actually used by all parties. If another measure is more appropriate (such as hours) then that measure should be used.

12 *Complete the following summary showing the total amount of each of the following types of transactions that took place during the annual accounting period of the foreign corporation between the foreign corporation (column (1)) and the persons described in columns (2) through (6).

(1) Transactions of controlled foreign corporation	(2) U.S. person filing return	(3) Any domestic corporation controlled by U.S. person filing return	(4) Any foreign corporation controlled by U.S. person filing return	(5) 10% or more U.S. shareholder of controlled foreign corporation (other than controlling shareholder)	(6) 10% or more U.S. shareholder of domestic corporation filing this return
(a) Sales of stock in trade (except in the ordinary course of business where neither party to the transaction is a U.S. person)					
(b) Sales of property rights (e.g., patents, trademarks, secret formulas, etc.)					
(c) Compensation received for technical, managerial, engineering, construction, scientific, or like services					
(d) Commissions received					
(e) Rents and royalties received					
(f) Amounts borrowed (other than open accounts which arise and are collected in the ordinary course of business)					
(g) Dividends received					
(h) Interest received					
(i) Premiums received for insurance or reinsurance					
Total (lines (a) through (i))					
(j) Purchases of stock in trade (except in the ordinary course of business where neither party to the transaction is a U.S. person)					
(k) Purchases of tangible property other than stock in trade (except where neither party to the transaction is a U.S. person)					
(l) Purchases of property rights (e.g., patents, trademarks, secret formulas, etc.)					
(m) Compensation paid for technical, managerial, engineering, construction, scientific, or like services					
(n) Commissions paid					
(o) Rents and royalties paid					
(p) Amounts loaned (other than open accounts which arise and are collected in the ordinary course of business)					
(q) Dividends paid					
(r) Interest paid					
Total (lines (j) through (r))					

If an entry would be made in the above schedule except for the fact that no compensation was paid, indicate the categories in which this has occurred.

*If the U.S. person is a bank, as described in section 581, or is controlled within the meaning of section 368(c) by a bank, the term "transactions" must not, as to a corporation with respect to which a return is filed, include banking transactions entered into on behalf of customers. However, deposits in accounts between a foreign corporation controlled by a U.S. person, and a bank, and withdrawals from accounts must be summarized by reporting end-of-month balances.

13 (a) The following financial statements for the annual accounting period of the foreign corporation must be filed with and made a part of this return: (1) profit and loss statement for the period; (2) balance sheet as of the end of the period; and, (3) analysis of changes in surplus accounts (include both opening and closing balance). These statements must be filed in conformity with generally accepted accounting principles, and in such form and detail as is customary for the corporation's accounting records.

(b) Enter gross receipts or gross sales (less returns and allowances) from the profit and loss statement required in item 13(a)(1)	
(c) Enter total assets (net) from the balance sheet required in item 13(a)(2)	

14 Exchange rate used (if more than one rate is used, attach statement) ▶

15 Complete the following for persons with whom this return is jointly filed or on whose behalf it is filed:

Name	Address

Instructions

(References are to the Internal Revenue Code)

A. Requirement of Return.—Every U.S. person must make a separate annual information return on Form 2952 with respect to each annual accounting period of each foreign corporation that person controls for an uninterrupted period of 30 days or more during such annual accounting period.

B. Nature of Business.—See page 7 of the instructions to Form 1120 for list of principal business activities and business activity code numbers.

C. Principal Cities and Countries where Business is Conducted.—List those places of business from which the largest portion of gross receipts shown in line 13(b) is derived.

D. U.S. Person.—The term "U.S. person" means:

- (1) a citizen or resident of the United States,
- (2) a domestic partnership,
- (3) a domestic corporation, and
- (4) any estate or trust (other than a foreign estate or foreign trust within the meaning of section 7701(a)(31)).

Enter all transactions of an affiliated group which filed a consolidated return in column 2 of item 12. Enter transactions of domestic subsidiaries with which a consolidated return was NOT filed in column 3 of item 12.

See section 1.6038-2(d) of the regulations for exception of certain residents of U.S. possessions.

E. Control.—A person will be deemed to be in control of a foreign corporation if he owns stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of shares of all classes of stock of the foreign corporation. A person in control of a corporation which, in turn, owns more than 50% of the combined voting power, or of the value, of all classes of stock of another corporation is also treated as being in control of such other corporation.

Example.—Corporation A owns 51% of the voting stock in Corporation B. Corporation B owns 51% of the voting stock in Corporation C. Corporation C in turn owns 51% of the voting stock in Corporation D. Corporation D is controlled by Corporation A.

F. Attribution Rules.—For the purpose of determining control of domestic or foreign corporations, the constructive ownership rules of section 318(a) apply, except that:

- (1) Stock owned by or for a partner or a beneficiary of an estate or trust will not be considered owned by the partnership, estate, or trust when the effect is to consider a U.S. person as owning stock owned by a person who is not a U.S. person.
- (2) A corporation will not be considered as owning stock owned by or for a 50% or more shareholder when the effect is to consider a U.S. person as owning stock owned by a person who is not a U.S. person.
- (3) If 10% or more in value of the stock in a corporation is owned, directly, or indirectly, by or for any person, section 318(a)(2)(C) will apply.

G. Period Covered by Return.—The information required by this return must be furnished for the annual accounting period of the foreign corporation ending with or within the U.S. person's taxable year.

H. Time and Place for Filing Return.—Returns on Form 2952 must be filed with the U.S. person's income tax return. An application for an extension of time for filing a return of income is also considered as an application for an extension of time for filing Form 2952.

I. Distributions Out of Accumulated Earnings and Profits.—If any distributions are made by the foreign corporation to shareholders with respect to their stock out of accumulated earnings and profits for prior years, enter in item 11(d) the total amount of such distributions and attach a schedule showing the years during which the earnings and profits were accumulated. (The distributions are deemed to be made out of the most recent prior years' accumulated earnings and profits, working backwards.)

J. Distributions Out of Other Than Earnings and Profits.—To the extent that distributions made by the foreign corporation to shareholders with respect to their stock exceed the current and prior years' accumulated earnings and profits, enter in item 11(e) the total amount of other distributions. Attach a schedule showing the amount that is applied against the shareholders' basis, and the amount that is treated by the shareholders as capital gain distributions.

Also, include in the schedule the amount of any distributions by the con-

trolled foreign corporation which are made to shareholders in redemption of stock, or in partial or complete liquidation.

K. Two or More Persons Required to Submit the Same Information.—If two or more persons are required to furnish information with respect to the same foreign corporation for the same period, the persons may, instead of making separate returns, jointly make one return. The joint return must be filed with the income tax return of any one of the persons making such joint return.

L. Persons Exempted from Furnishing Information.—Any person required to furnish information under section 6038 with respect to a foreign corporation need not furnish that information if all of the following conditions are met:

- (1) The person does not directly own an interest in the foreign corporation;
- (2) The person is required to furnish the information solely by reason of attribution of stock ownership from a U.S. person; and
- (3) The person from whom the stock ownership is attributed furnishes all of the information required of the person to whom the stock ownership is attributed.

M. Statement Required.—Any person who is required to file this return but does not do so because the information will be furnished by another person must file a statement with his return indicating that such liability will be satisfied and identify the return with which the information will be filed and the place of filing. The statement below may be used for this purpose.

N. Penalties.—The information required by section 6038 must be furnished even though there are no foreign taxes which would be reduced. For criminal penalties for failure to file a return and filing a false or fraudulent return, see sections 7203, 7206, and 7207.

O. Effect on Tax Credit.—Failure to furnish any information required by section 6038 will result in a reduction in the foreign taxes which are taken into account when figuring the credit under sections 901, 902, and 960 as provided in detail in paragraph (l) of section 1.6038-2 of the regulations.

Statement in Regard to Filing Requirement of Form 2952

I have not filed Form 2952 because (check applicable box):

- I am exempted from filing and information will be furnished by the person from whom the stock ownership is attributable.
- A joint return has or will be filed.

Person filing this statement		The information required to be furnished on Form 2952 will be filed by	
Name		Name	
Address		Address	
Identifying number	Year	Internal Revenue Service Center	Identifying number

SUMMARY OF PRICING METHODSFOR THE TRANSFER OFTANGIBLE PROPERTY

Treasury Regulations 1.482-2(e)(1) establish three methods for making adjustments: the comparable uncontrolled price method, the resale price method, and the cost plus method. All three require reference to similar transactions between unrelated businesses. Each method must be considered in the order in which it is listed. Ordinarily, no pricing method can be used unless the preceding ones are rejected as unsuitable. If all three are rejected, some other appropriate, but undefined transfer price method may be used.

Comparable uncontrolled price method

The first and most preferred method is to base the adjustment on a price obtained from a comparable uncontrolled transaction. In this method, the examiner must identify the price paid in a comparable uncontrolled transaction. Uncontrolled transactions are defined as sales between two businesses who are not members of the same controlled group. They include:

- Sales by a member of the controlled group to unrelated businesses.
- Sales to a member of the controlled group by unrelated businesses.
- Sales in which the businesses are not members of the controlled group and are not related to each other.

Uncontrolled transactions at unrealistic prices cannot be used to justify an adjustment. For example, sales in small quantities cannot be used to justify a comparable uncontrolled price on a large volume of sales.

Since a number of factors can affect the price of a sale, this method requires that the uncontrolled transactions be carefully reviewed for comparability with controlled transactions. The product sold in the controlled and uncontrolled transactions should be reasonably similar.

Resale price method

If an arm's length price cannot be established under the comparable uncontrolled price method, the examiner must proceed

to the resale price method. This method requires working backward from the price at which the buyer resells a product, originally purchased from a related member of the controlled group, to an unrelated business. The resale price is reduced by an amount which reflects the seller's gross markup or value added. This should include all costs incurred in adding to the value of the product plus a reasonable profit. While the comparable uncontrolled price method is based on a comparable price, the resale price method is based on a comparable markup. The arm's length price of the initial controlled sale is arrived at by reducing the resale price by the appropriate markup.

According to the regulations this method should be used where no comparable uncontrolled sales exist and where the buyer does not add substantially to the value of the product. This would be the case where the buyer, for example, stores or repackages an item purchased in a controlled sale, or perhaps merely processes paperwork on the item but does not modify it significantly with substantial manufacturing activity.

Cost plus method

The cost plus method is used when neither the comparable uncontrolled price method nor the resale price method can be applied. The cost plus method is usually applicable when a manufacturer sells all of its output to a related corporation which then adds its trademark or trade name, or substantially modifies the product before its resale.

The starting point in establishing the arm's length price under this method is the cost of the property sold in the controlled transactions. To this cost is added markup. The balance must then be adjusted for any material differences that have an ascertainable impact on price, between the sales from which the appropriate markup percentage is derived and the controlled transactions.

The markup is arrived at by multiplying the cost of the property sold in the controlled transactions by an appropriate gross profit percentage. As in the resale price method, the objective is to find a comparable markup.

Other pricing methods

Treasury Regulation 1.482-2(e)(iii) provide that if none of the three pricing methods can be applied, some other method or a variation of the three methods can be used to establish a price on which to base the adjustment. While the regulations provide a fourth or other method, they provide no guidance to IRS examiners and economists in establishing a price under it. It is left

up to the examiner or economist to choose a method most suitable to the situation. According to IRS' training manual for international examiners, some alternative methods that may be used are:

1. Rate of return on investment method, where the arm's length price is arrived at by using a rate of return expressed as a percentage of capital invested in the manufacturing of the particular property involved in the controlled sale or in the capital invested in a particular function.
2. The ultimate sales price method, where the starting point in establishing the arm's length price is the third-party sales price. Working backwards, the examiner or economist arrives at the arm's length price by adjusting for functions performed by the related buyer or buyer-reseller. The adjustment is determined by first identifying the cost of the functions and then ascribing a profit to them.
3. Functional method, where a comparison of the functions performed rather than prices of the property is made in determining the arm's length price. The examiner or economist compares the functions performed by the unrelated party with those of the corporation even though the property sold by the unrelated party performing the function is dissimilar to the property involved in the controlled sale.

FACTORS TO BE CONSIDERED IN
ESTABLISHING AN ARM'S LENGTH RATE
FOR INTANGIBLE PROPERTY

Intangible assets are considered one of the most important assets owned by a business entity. Treasury Regulation 1.482-2(d)(3) defines intangible property as:

1. Patents, inventions, formulas, processes, designs, patterns, and other similar items.
2. Copyrights, literary, musical, or artistic compositions, and other similar items.
3. Trademarks, trade names, brand names, and other similar items.
4. Franchises, licenses, contracts, and other similar items.
5. Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

Additional items that may be considered intangible property are goodwill, key employees, and consumer acceptance.

The regulations also add this qualification to its definition of intangible property--"provided that such items have substantial value independent of the services of individual persons."

When comparable uncontrolled dealings cannot be found, Treasury Regulation 1.482-2(d)(2)(iii) states that the following factors may be considered in establishing a rate on which to base the adjustment:

1. The prevailing rates in the same industry or for similar property in a different industry.
2. The offer of competing transferors or the bids of competing transferees.
3. The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted.
4. The uniqueness of the property and the period for which it is likely to remain unique.

5. The degree and duration of protection afforded to the property under the laws of the relevant countries.
6. Value of services rendered by the transferor to the transferee in connection with the transfer within the meaning of paragraph (b)(8) of this section (services rendered in connection with the transfer of property).
7. Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property.
8. The capital investment and starting up expenses required of the transferee.
9. The availability of substitutes for the property transferred.
10. The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties.
11. The costs incurred by the transferor in developing the property.
12. Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

Adjustments Involving
Loans And Advances, Services, And
Use Of Tangible Property

<u>Method used</u>	<u>Loans and advances</u>		<u>Services</u>		<u>Rents</u>		<u>Total</u>	
	<u>No.</u>	<u>Amount</u>	<u>No.</u>	<u>Amount</u>	<u>No.</u>	<u>Amount</u>	<u>No.</u>	<u>Amount</u>
Safe haven rules	83	\$12,608,403	153	\$45,792,993	4	\$2,009,373	240	\$60,410,769
Arm's length standard:								
Comparable uncon-	0	0	3	1,889,170	1	852,416	4	2,741,586
trolled transactions	1	207,316	25	6,795,524	0	0	26	7,065,840
Alternative methods								
Not determinable from report	0	0	3	110,789	1	12,000	4	122,789
Total	84	\$12,878,719	184	\$54,588,476	6	\$2,873,789	274	\$70,340,984

Tax Audit Guidelines, Individuals, Partnerships, Estates and Trusts,
and Corporations

page 4233-168.1
(10-19-79)

Exhibit 600-9

Pointers to International Tax Avoidance



The Guidelines are divided into the following three general categories:

- A. General Matters.
- B. The Balance Sheet.
- C. Profit and Loss Items.

A. General Matters

1. *Member(s) of corporate group located in tax haven(s).* A tax haven can be described as any country whose laws provide an escape from taxes on an economic gain which would otherwise be taxable in another country. For example, a country may have a low or no tax on income or a type of income. It may also allow a deduction that is not allowable in the other country. There is a great incentive to divert profits and other income to parent or subsidiary corporations organized in tax havens.

2. *Dual use of tax havens.* A multinational group may use a tax haven to advantage both in the purchase and sale of goods. By adroitly invoicing goods through a tax haven affiliate, the greater portion of the profit, unrelated to any functions performed by the tax haven affiliate, can be erroneously recorded in the affiliate. Likewise, reversing the technique, a United States corporation can be overcharged for goods purchased from a tax haven affiliate, thereby creating an unallowable tax deduction for the United States corporation.

3. *Consolidated figures for world group better than domestic corporation results.* This type of situation can be an indication that the profits of the United States corporation are being diverted to a tax haven.

4. *Group Organization.* In a corporate group structure, ascertain if each corporation has a valid function. An "unexplained" corporation may be a vehicle for tax avoidance. An analysis of the taxpayer's copies of Securities and Exchange Commission Forms 8K and 10K and the Form 959 (Return by an Officer, Director or Shareholder with Respect to the Organization or Reorganization of a Foreign Corporation and Acquisition of its Stock) print-out, maintained by the Regional Program Manager-International, can be used as a starting point to determine all foreign entities owned by a United States taxpayer.

5. *Associated by common control rather than group membership.* There is need in practice to watch for transactions between companies which are under common control but which do not simply belong to the same group.

6. *Domestic branches of foreign corporations.* It should be ascertained whether or not

the foreign corporation is engaged in a trade or business in the United States and subject to United States taxation.

7. *Permanent loss-makers.* This can indicate the possibility of less than arm's length transactions and relationships with suppliers and/or customers.

8. *Domestic International Sales Corporation.* DISC transactions should be scrutinized to determine if the election, qualifications and pricing arrangements are proper.

B. The Balance Sheet

1. *Repatriation of foreign profits as loans.* Loans from foreign affiliates may represent the repatriation of foreign profits and an attempt to avoid payments of dividends to an affiliate United States corporation.

2. *Excessive balances with affiliates.* Excessive credit or debit balances with foreign affiliates may indicate non arm's length transactions between the parties which have not, and perhaps will not in fact be paid.

3. *Write-offs of intercompany debt.* This can be an attempt to reduce accumulated intercompany balances that may have resulted from less than arm's length transactions.

4. *Investment and receivables held through or by foreign subsidiaries.* Banks may lend funds to tax haven subsidiaries for investments, but allege that they are only lending as part of ordinary banking business at commercial rate. Loans or investments may be made in United States property, subject to dividend consideration.

5. *Absence of expected assets or liabilities in a company's accounts.* Such omissions may indicate the assignment, transfer or sale of such intangible assets as patents, know-how, trade secrets, etc. to a tax haven affiliate.

C. Profit and Loss Items

1. *Research and development.*

a) *High technology industries.* These industries are intensively engaged in research and development. They are particularly prone to tax avoidance schemes because of their high gross profit margins. The U.S., in this respect, provides tax sheltering opportunities as I.R.C. Sec. 174 allows a current deduction for research and development expenditures.

Exhibit 600-9 Cont. (1)

Points to International Tax Avoidance ◇

b) *Hidden research and development expenditures.* Certain expenses are sometimes booked in specific accounts; however, larger amounts may be passed through cost of sales accounts. The total expense (including payments to other group members) should be established.

a) *Pooled research and development ex-*

directly to third parties may exploit their monopoly position by transferring the patents to tax haven subsidiaries to serve as licensors.

b) *Payments in respect of expired patents.* Any payment in respect of patents which have expired needs further investigation.

c) *Reciprocal benefits.* Where a corporation pays royalties to a foreign affiliate for use of a patent, consider whether the company is ade-

Exhibit 600-9 Cont. (2)**Pointers to International Tax Avoidance** ◇

11. *Invoice to one party, shipment to another.* Separation of a transaction in this way may indicate a tax avoidance scheme.

12. *Adequate compensation of officers.* If officers of a United States corporation also serve as officers of foreign affiliates, check if the officers' compensation is being properly allocated as an expense of the affiliated foreign corporations relative to the executive services the officers perform for each corporation.

13. *Rental accounts.* Details of the use of premises occupied by foreign affiliates may indicate the extent and nature of their activities.

14. *Internal chartering arrangements in shipping groups.* Non arm's length rates may be charged between companies in controlled group, particularly to or by affiliates in tax havens. Long term charters may be concluded to take advantage of unusual rises or falls in the general level of the freight rates.

15. *Changes in the pattern of accounts.* Any major changes such as decrease in gross or net profits, volume of business, debit and/or credit balance inter-company accounts as they relate to dealings with foreign affiliates, should be analyzed to ascertain to the reason for the changes.

16. *Travel expense.* If a domestic entity deducts expense of travel to its foreign affiliate, such expense, along with similar expenses, could be allocated to the foreign corporation under Section 482, depending upon the facts of the instant case. Also, in which case, such travel expenditures would be considered allocable to foreign sourced income for the purposes of computation of the foreign tax credit limitation of the domestic affiliate.

17. *Domestic parent companies with affiliates with possessions of the United States.* Such possession corporations are exempt from taxation. In these circumstances, transactions

between parent and subsidiary should be watched closely.

18. *Net operating losses of affiliates.* During a period of worldwide economic recession, sales affiliates of foreign corporations should be closely watched for large net operating losses carried back to profit years, and the recapture of all previously paid tax. Foreign corporations with excessive losses, or in bankruptcy status, may make excessive charges to their affiliates.

19. *Presence of ruling letter.* If any transactions involved a reorganization between a domestic and foreign entity, a ruling letter should be present.

20. *Liquidation or sale of a foreign affiliate.* This may reveal areas where foreign income was accumulated, or shifting occurred. Also, the possible conversion of ordinary income into capital gain may be present.

21. *Payments to foreign entities by domestic corporations.* Where a payment of income has been made to a foreign entity from sources within the United States such as wages, rents, dividends, interests or other fixed or determinable annual or periodic income not effectively connected with the conduct of trade or business in the United States, it should be determined whether a liability for withholding tax exists and whether Forms 1042 were filed.

22. *Captive Offshore Insurance Companies.* The potential tax advantages of a captive offshore insurance company (COIC) have been noted by tax practitioners and by the IRS. A COIC is a foreign subsidiary of a U.S. parent corporation that is formed solely to insure the casualty risks of its U.S. parent and the parent's foreign and domestic subsidiaries. See IRM 45(11)9, Rev. Rul. 77-316, 1977-2 C.B. 53, and 78-338, 1978-2 C.B. 107, and Carnation Company U.S. Tax Court 71 TC No. 39.

Examples Of FunctionsInvolved In A Transaction And TheCorporation Which Performed Them

<u>Functions performed</u>	<u>Performed by</u>	
	<u>U.S. parent</u>	<u>Foreign subsidiary</u>
a. Designed and developed factory machinery equipment	X	
b. Did product planning and development	X	
c. Purchased raw materials	X	
d. Fabricated clips	X	
e. Molded lead around clip	X	X
f. Boxed and packed completed wheel weights for shipment to parent customers (label addressed to parent customers)	X	X
g. Warehoused finished wheel weights in U.S.	X	
h. Sold:		
1. Direct to large customers		
2. Through jobbers to others	X	
i. When orders received through jobbers:		
1. Issued shipping instructions	X	
2. Billed and collected	X	
j. Supplied technical services:		
1. Controlled flow of raw materials	X	
2. Controlled flow of finished products	X	
k. Paid freight:		
1. Clips and raw materials parent-foreign		X
2. Completed weights foreign-parent	X	
l. Manufactured standard weights (large volume)	X	X
m. Manufactured special weights (low volume)	X	
n. Manufactured wheel balancing machines	X	
o. Owned patent on and licensed use of wheel balancing procedure	X	

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

26 JUN 1981

Mr. William Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

I appreciate the opportunity to review your draft report entitled, "Allocation of Income and Deductions Within Multinational Corporations--A Growing Problem for IRS, Treasury and Corporate Taxpayers." I have included our specific comments on each of the recommendations as Enclosure I and more detailed technical comments as Enclosure II.

In general we agree with the recommendations for IRS in the report. However, in terms of your recommendation to Treasury (which of course would directly affect the Service), we are not sure that we have yet had sufficient experience with the current Section 482 regulations to participate in a wholesale reconsideration of the arm's length price premise of such regulations.

We have been informed that the Treasury Department has current plans for revising part of the Section 482 regulations. In particular, a notice of proposed rulemaking revising the regulations relating to the use of tangible property may be published shortly. Also under study is whether to amend the Section 482 regulations relating to a "safe-haven" rule for the sale of tangible property. We think that this approach of improving parts of the Section 482 regulations may be more beneficial than a one-time reworking of the Section 482 regulations en masse, which the report seems to suggest.

We have some reservations concerning the statistics used in the study. The report omits \$330 million from the base information developed to arrive at a net of 200 cases closed with recommended Section 482 income adjustments of \$277.5 million. For the period under study, there were actually 235 cases closed by the Examination Division with recommended Section 482 income adjustments of \$607 million.

The Study data also does not include any cases of the oil industry, one of the largest industries in which we have significant 482 adjustments. This apparently occurred because these cases were not closed during the period of the study even though their taxable year (1973) fell within its scope. These adjustments alone are in excess of \$600 million annually.

Department of the Treasury Internal Revenue Service

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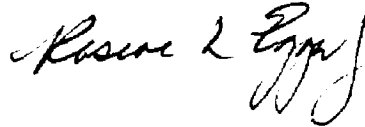
Mr. William Anderson

In addition, the report specifies that only 3% (12 of 403) Section 482 adjustments were made using prices based upon comparable uncontrolled transactions. This fails to take into account the fact that 240 of the 403 adjustments were attributable to situations where safe haven adjustments were mandatory. Even without factoring this in, more current IRS information (FY 1980) indicates that 75 of 375 or 20 percent of recommended Section 482 adjustments were based on arm's length prices using the comparable uncontrolled method.

Finally, in the section in the report (pg. 49) discussing the use of formula apportionment, I believe it would be useful to consider incorporating a comment on the decision of the Organization for Economic Cooperation and Development (OECD) to recommend the adoption of a similar system to IRC 482 (arm's-length standard). OECD dropped the unitary method since some foreign countries experienced problems in administering the law.

With kind regards,

Sincerely,



Enclosures

Enclosure I

IRS COMMENTS ON GAO RECOMMENDATIONS IN DRAFT REPORT ENTITLED,
"ALLOCATION OF INCOME AND DEDUCTIONS WITHIN MULTINATIONAL
CORPORATIONS—A GROWING PROBLEM FOR IRS, TREASURY AND CORPORATE TAXPAYERS"

Page 25, Recommendation 1

Aggregate and analyze existing data from a management perspective, consider ways to get a better measure of noncompliance, and establish procedures for continuously assessing the appropriateness of IRS' position.

Comments

We concur. Within the constraints of our budget and without any significant increase in costs, IRS will expand its present IRC 482 Study to improve its management information to make better informed decisions. IRS has already acted to protect U.S. interests in international tax enforcement. We have established Simultaneous Examination Programs and Industrywide Exchanges of Information with certain tax treaty countries to obtain a better understanding of international operations and selected industries. The Service's IRC 482 Study now provides management with measures of noncompliance, data on the extent that multinational corporations conduct inter-corporate business (the arm's-length standard) as well as information on how well IRS enforcement efforts are succeeding in recouping tax losses. On this latter point, over the past 10 years our Examination Division recommended over \$9.5 billion in additional taxes (a 442 percent increase) for all international issues. While we do not have specific information for earlier years, Section 482 adjustments accounted for approximately 32 percent of the total additional tax for all international issues in FY 1980. We estimate over \$2 billion in additional taxes will be recommended for all international issues in FY 81. The following illustrates the significant growth for this period.

<u>YEARS</u>	<u>ADDITIONAL TAX AND PENALTIES (MILLIONS)</u>
FY 70	332
FY 71	205
FY 72	407
FY 73	701
FY 74	704
FY 75	880
FY 76	597
FY 77	686
FY 78	868
FY 79	1.400
FY 80	1.800
FY 81 (6 months ending 3/31/81)	<u>1.200</u>
TOTAL	\$ <u>9.780</u>

The 482 Study also provides management planning strategies for more effective use of Examination resources. The IRS recognizes that more action is needed and will explore ways of improving its Section 482 enforcement. In addition to its IRC 482 Study, IRS has the following efforts underway:

1. Analyze international examiners' reports to identify intercorporate transactions and ensure the recoupment of tax losses.
2. Analyze information concerning the ownership of foreign corporations and payments to nonresident foreign corporations to identify the universe of multinationals.
3. Develop tabulations from the TCMP questionnaire covering international issues (including Section 482) for 1980 corporate returns with assets less than \$10 million. The purpose is to identify the universe and select returns within the class.

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4. Develop a revised field report to identify the total universe of cases, dollars, referrals, breakdown of other than large cases as well as large case activities and examination results.
5. Develop a project proposal to add Appeals, Competent Authority, and litigation results for Section 482 cases.
6. Continue testing a system to evaluate the results of large corporate audit cases. The system's specific purpose is to determine the audit productivity of certain issues (including IRC 482) through the various levels of administrative and judicial appeals. Although tracking a corporate audit by issue and industry would enable us to make more effective use of our resources, our computer capacity forces us to limit this effort to our largest corporate returns in a few regions, i.e., the Coordinated Examination Program (CEP). When additional computer capacity becomes available, we plan to expand it to all regions.

Page 25, Recommendation 2

Reassess the appropriateness of IRS criteria for requesting economist participation in Section 482 adjustments and require that participation be mandatory for all adjustments that meet the criteria established.

Comments

We concur. We will reassess the criteria for requesting economic assistance as contained in IRM 42(12)3 and require mandatory participation for all identified Section 482 adjustments that meet the criteria established.

Page 25, Recommendation 3

Require IRS economists to evaluate whether the information they develop in one examination would be useful in other examinations and establish a procedure for communicating such information to other audit teams which examine corporations having similar operations or products.

Comments

We concur. We will evaluate the present procedure used to communicate information developed by economists to revenue agents examining corporate tax returns with similar operations and make any necessary changes as long as we do not violate disclosure restrictions in IRC Sec. 6103.

Page 25, Recommendation 4

Clarify the description of the information that corporations should report concerning the sale and purchase of stock in trade and intercorporate loan transactions either by revising the Form 2952 when current supplies are depleted or by issuing the new consolidated form currently being developed. In the interim, IRS should notify its examiners of the shortcomings in the present form.

Comments

The recommendations to change the Form 2952, regarding "Sales and Purchases of Stock in Trade" and "Intercorporate Loans" will be considered. The current wording on the Form 2952 is taken directly from Section 1.6038 of the Income Tax Regulations. A change to the regulations may be necessary in order to change the Form 2952. The proposed Form 5471 does eliminate the exceptions now on Form 2952; but until it is issued (which could be quite some time because of the overall complexity of this form), examiners will be notified of these exceptions on Form 2952, and instructed to request the additional information.

TECHNICAL COMMENTS

1. The draft report states that a "Treasury official" said that Treasury has plans to consider implementation of a self-adjusting safe haven interest rate for Section 482. See page 18 of chapter 1. According to our Legislation and Regulations Division this proposal has been considered and rejected (LR-221-78). However, apparently there was significant support for a self-adjusting safe haven interest rate and reconsideration is always possible. Note, also, that the final regulations increasing the safe haven interest rates under Section 482 to the 11 to 13 percent level will be promulgated on July 1, 1981.

2. The GAO report on page 1 of the cover summary mentions exploitation of disparate corporate tax rates (lower foreign tax rates) as the motivation for shifting income abroad. We believe the report should also mention that other reasons exist for shifting income abroad. For example, taxpayers may seek to shift income abroad to increase their Section 904 foreign tax credit limitation. In addition, sometimes income is shifted abroad merely to appease foreign tax authorities, with the knowledge that the tax has to be paid somewhere and with the expectation of an offsetting United States foreign tax credit. Cf. Rev. Rul. 76-508, 1976-2 C.B. 225.

3. Chapter 1, page 2, of the report in discussing the legislative history of Section 482 states that the Senate Finance Committee indicated that the original predecessor of Section 482 was necessary to prevent the arbitrary shifting of profits among related businesses, particularly in the case of

-2-

subsidiary corporations organized as "foreign corporations." Actually the Senate Finance Committee used the term "foreign trade corporations" which at the time were defined as domestic corporations operating outside the United States, rather than foreign corporations as the GAO study states. See S. Rep. No. 275, 67th Cong., 1st Sess 20 (1921), 1939-1 (Part 2) C.B. 181, 195, and H.R. Rep. No. 486, 67th Cong., 1st Sess. 14-15, Amend. No. 8, 1939-1 (Part 2) C.B. 206, 207. We suggest that the reference to the Senate Finance Committee be modified to state:

The Senate Finance Committee believed Section 240(d) was necessary to prevent the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized to conduct business in foreign countries.

4. In several places the report indicates its drafters spoke with the Office of the Deputy Chief Counsel but fails to mention which Deputy Chief Counsel. We assume the drafters of the GAO report spoke with representatives of the Office of the Deputy Chief Counsel (Technical).
5. On page 29 of the report, GAO shows with respect to tangible personal property that 5 of 34 (15 percent) of the recommended 482 adjustments used the comparable uncontrolled method. Current IRS information for FY 80 shows that 40 of 60 (67 percent) of the recommended 482 adjustments used the comparable uncontrolled pricing method. For the 6-month period ended 3/31/81, 41 of 101 (41 percent) of the cases closed showed that IRS adjustments used the comparable uncontrolled method. The average for the 18-month

-3-

period was 50 percent of the total 482 recommended income adjustments by the Examination Division. Further evidence to show that GAO's statistical information does not support its conclusion is reflected in the results of previous studies that show 21 to 28 percent of the total adjustments involved the use of comparable uncontrolled methods. The following illustrates this point:

Tangible Property - Percent of Adjustments Using Pricing Method
Alternative Methods

<u>Study</u>	<u>Year of Study</u>	<u>Comparable Uncontrolled</u>	<u>Alternative Methods</u>			<u>Sub Total</u>	<u>Total</u>
			<u>Resale</u>	<u>Cost Plus</u>	<u>Other</u>		
Conference Board	1972	28	13	23	36	72	100
Department of Treasury	1973	21	11	27	41	79	100
Indiana University	1980	24	14	30	32	76	100
IRS - Current Information	FY 80 to Present	50	13	17	20	50	100

6. On page 42 of the report, GAO, using information from the Conference Board Report in 1972, states that corporations, courts, tax experts, and IRS officials have criticized the Section 482 regulations. IRS contends that GAO should use current information such as the Dr. Burns Study of 1980 which does not reflect such views.

GAO Note: Page references refer to the draft report and do not necessarily correspond to the final report.



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

JUL 10 1981

Dear Mr. Anderson:

I appreciate the opportunity to present the Treasury Department's comments on the draft GAO report "Allocation of Income and Deduction Within Multinational Corporations --- A Growing Problem for IRS, Treasury and Corporate Taxpayers".

In general, the report contains useful information, but we have substantial reservations about its conclusions with respect to the problems associated with intercompany pricing. Our specific comments are set forth below.

Formula Apportionment

Our principal concern with the draft report is the recommendation that the Treasury consider the adoption of formula apportionment as a substitute for the "arm's-length" principle in the current regulations. This preference for formula apportionment is not based on any analysis of the conceptually correct method for intercompany pricing, which should be the starting point for any review of the 482 regulations. In terms of economic rationale, formula apportionment has little merit because a corporation could have an increased tax burden merely as a result of its affiliates becoming more profitable or as a result of paying higher wages in the jurisdiction applying the formula. It therefore does not attempt to achieve the statutory objective of correctly reflecting a taxpayer's income.

Formula apportionment is not, as the report indicates, widely used by the states in a multicorporate context. Rather, it is, with very few exceptions, used by the states only to divide the income of a single multistate corporation, which is a totally different matter.

The report's case for formula apportionment rests entirely on the view that it would be administratively convenient and reduce taxpayer uncertainty. Even on this basis, however, the report is not convincing because it minimizes the practical problems with respect to formula apportionment. The report does not demonstrate how such methods would improve or simplify the illustrative cases. An example of an important practical problem in applying formula apportionment in a multinational situation is the definition of a unitary business. In that regard, the report is unrealistic in assuming that an advance ruling system for determining the composition of the unitary group would be

-2-

administratively simple. Another significant practical problem is the valuation of intangibles, which would be important for many high technology multinationals.

It would also be useful for the report to review the experience of jurisdictions that have used the unitary method. Some of the few states who use it, such as California, are considering abandoning it. The experience of European countries contributed to the very strong OECD criticism of "global" methods in its 1979 report on transfer prices. Moreover, formula apportionment is not consistent with our present treaty policy. Finally, the unitary method has been alleged to create an unfavorable business climate for foreign corporations doing business in a unitary state.

The Availability of Comparable Uncontrolled Prices

The report concludes that the present regulation is seriously defective because the comparable uncontrolled price method is only infrequently used in IRS adjustments. We understand that the IRS has made data available to you indicating that uncontrolled prices are used much more frequently than your data indicates. In any case, the report fails to adequately recognize that the other methods outlined in the regulations are only alternatives for arriving at an arm's-length price, not departures from that principle. Furthermore, there is no specific indication that uncontrolled prices are not used in cases of intercompany pricing which do not lead to an IRS adjustment.

Whatever the exact frequency with which uncontrolled prices are available, they are readily available in a number of cases. In that regard, should formula apportionment be used even when uncontrolled prices are available?

Evidence on the Shortcomings of the Current Regulations

Much of the other data presented to demonstrate problems with the current regulations are misleading or unpersuasive. For example, the report states that "only" 200 of the 519 multinational corporations in the GAO sample had Section 482 adjustments. These data are subject to various interpretations and do not necessarily reflect difficulties with applying the current Section 482 regulations. Furthermore, the report states that Section 482 adjustments amounted to "only" \$277.5 million compared to the total income of the examined firms of \$43.5 billion. The use of total income as the standard for comparison has no logical basis because, among other reasons, a significant

-3-

portion of the income may be unrelated to transactions between affiliates. Finally, the many examples of Section 482 cases discussed in the report are informative, but they do not necessarily relate to the report's major conclusions and the recommendations to the Secretary of the Treasury.

Safe Haven Interest Rate

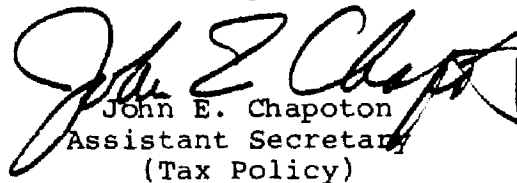
The report recommends that "the treasury adjust the safe haven rate as frequently as necessary to realistically reflect the current costs of borrowing." As you are aware, a change in safe haven interest rate has been implemented effective July 1. The Treasury has explored the use of self-adjusting rate but has found that it would lead to many practical problems for taxpayers. However, we anticipate that the safe haven interest rate will be adjusted periodically in the future to reflect major changes in interest costs.

Future Work

These comments are not intended to suggest that there are no problems with the application of the current Section 482 regulations. We realize that the arm's-length principle may have both conceptual and practical limitations in a world of integrated firms selling differentiated products. The Treasury has examined and will continue to examine specific problems in the regulations, and will propose changes if they appear useful or warranted. We will also work with the IRS on issues raised by the recently completed survey on 482 adjustments. However, additional analysis is necessary before we can conclude that a major review of the regulations is warranted.

My staff will be happy to expand on our comments.

Sincerely,


John E. Chapoton
Assistant Secretary
(Tax Policy)

Mr. William J. Anderson
Director
General Government Division
U.S. General Accounting Office
Washington, D.C. 20548

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