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Testimony

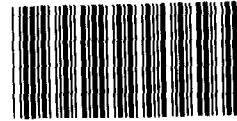
Before the Committee on Governmental Affairs,  
U.S. Senate

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INTERNATIONAL  
TAXATION

Updated Information on  
Transfer Pricing

Statement of Natwar M. Gandhi  
Associate Director, Tax Policy and Administration Issues  
General Government Division



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UPDATED INFORMATION ON  
TRANSFER PRICING

SUMMARY STATEMENT OF  
NATWAR M. GANDHI  
ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES  
GENERAL GOVERNMENT DIVISION  
U.S. GENERAL ACCOUNTING OFFICE

For each year from 1987 through 1990, about 72 percent of foreign-controlled corporations paid no U.S. income tax, compared to about 59 percent of U.S.-controlled corporations. The 207 foreign-controlled corporations with assets of \$250 million or more that did not pay tax in 1989 received about 10 percent of the receipts and had 17 percent of the assets of all foreign-controlled corporations. Although data showing differences between foreign- and U.S.-controlled corporations could indicate potential transfer price abuse by foreign-controlled corporations, they do not prove such abuse.

The dollar amounts at issue between IRS and taxpayers in transfer pricing cases have remained large. IRS in 1992 proposed section 482 adjustments of at least \$1 billion for foreign-controlled corporations and at least \$3.1 billion for U.S.-controlled corporations. On September 30, 1992, at least \$14.4 billion of proposed section 482 adjustments had been protested by taxpayers to IRS' Appeals division and were awaiting resolution.

IRS' recent experience with section 482 cases has been difficult. In 1992, Appeals sustained only 24 percent of the dollar amount of section 482 adjustments proposed by IRS examiners. Also, IRS lost a significant section 482 issue for each of the five corporations that had a major section 482 case litigated and ruled on by a court between 1990 and 1992.

In the broader area of managing its international operations, IRS did not meet a couple of its acknowledged needs. It did not have operational a new system for capturing examination data that was to be used for 1992, and it had not yet implemented a staffing model to better assess its international staffing needs.

The challenges of section 482 cases will remain for at least two reasons. First, the growing influence of international forces on the U.S. economy will continue to increase the potential for underpayment of U.S. taxes through transfer pricing practices of multinational companies. This influence is demonstrated by the growing amount of merchandise exports of U.S. parent companies to their foreign affiliates, which increased from \$6 billion in 1966 to \$86 billion in 1989 and represented 24 percent of total U.S. merchandise exports in 1989. Second, while the new, temporary transfer pricing regulations have many promising features, they still require taxpayers and IRS examiners to collect great amounts of information and use considerable subjective judgment to compute arm's length prices.



Mr. Chairman and Members of the Committee:

We are pleased to be here today--at Senator Dorgan's request--to provide you information about transfer pricing<sup>1</sup> issues facing the Internal Revenue Service (IRS), specifically in the areas of tax payments of foreign-controlled corporations, exams, appeals, litigation, and new transfer pricing regulations. This information updates that published in our 1992 report, International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15, 1992).

Today we have four major points:

- Our review of 1989 and 1990 tax data showed that, as in previous years, a larger percentage of foreign-controlled corporations than U.S.-controlled corporations paid no income taxes in the United States.
- IRS' experience in dealing with transfer pricing issues has continued to be difficult, and the dollar amounts at stake have remained large. IRS examiners have increased their audits of foreign-controlled corporations, but IRS has not yet succeeded in sustaining examination findings from previous years through the appeals process and the courts. A staffing model to help allocate international staffing resources has not yet been adopted, and a new data system to capture all examination findings is not yet in place.
- IRS has moved toward using different tools in the transfer pricing area, such as advance pricing agreements and arbitration, but because of IRS' limited experience with them, it is too early to tell what their eventual impact will be.
- The challenges of section 482<sup>2</sup> cases will remain in the foreseeable future. Congress and IRS can expect continuing problems in this area for at least two reasons:
  - First, the growing global economy will likely increase the number of cross-border transactions and thus the potential for underpayment of U.S. taxes through transfer pricing practices of multinational companies.

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<sup>1</sup>Transfer prices are prices companies charge other related companies for goods and services transferred on an intercompany basis.

<sup>2</sup>Section 482 of the Internal Revenue Code gives the Treasury Secretary broad authority to allocate income among related parties in order to prevent tax evasion or clearly reflect the income of the parties.

-- Second, the arm's length standard--which is the standard the United States and other countries use to govern transfer pricing--will continue to be difficult for IRS to enforce. While new regulations in the area have many promising features, they still require taxpayers and IRS examiners to collect a great deal of information and use considerable subjective judgment to compute arm's length prices in an increasingly complex international business environment.

HIGHER PERCENTAGE OF FOREIGN-CONTROLLED  
CORPORATIONS DID NOT PAY TAX

As shown in table 1, for each year from 1987 through 1990, about 72 percent of foreign-controlled corporations paid no U.S. income tax, compared to about 59 percent of U.S.-controlled corporations.<sup>3</sup> We examined the nonpaying corporations by their 1989 asset size and found that 29,781 foreign-controlled corporations had assets lower than \$10 million and paid no income tax. These foreign-controlled companies comprised 66 percent of all foreign-controlled corporations, but they had only 3 percent of the receipts and about 2 percent of the assets of all foreign-controlled corporations. Similarly sized U.S.-controlled corporations that did not pay income taxes represented about 58 percent of all U.S.-controlled corporations.

In the group of very large corporations--that is, those with \$250 million or more in assets--207 of 693 foreign-controlled corporations did not pay taxes. These large, foreign-controlled corporations had about 10 percent of the receipts and 17 percent of the assets of all foreign-controlled corporations. In comparison, 1,555 of 4,650 U.S.-controlled corporations with \$250 million or more in assets did not pay tax in 1989. These large corporations had about 4 percent of the receipts and about 13 percent of the assets of all U.S.-controlled corporations. More information about foreign- and U.S.-controlled corporations and whether they paid taxes is provided in table 2 and appendix I.

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<sup>3</sup>Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

**Table 1: Foreign- and U.S.-Controlled Corporations Paying No Taxes, 1987 to 1990**

	Foreign-controlled corporations		U.S.-controlled corporations	
	Number of returns	Percent	Number of returns	Percent
1987	29,928	71	1,333,470	57
1988	33,636	73	1,310,698	58
1989	32,135	72	1,265,970	59
1990 (preliminary)	32,323	73	1,264,349	61

Note: These percentages are based on tax returns as filed and do not reflect IRS audits or net operating loss carrybacks that would result from any losses in future years. Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.

**Table 2: Foreign- and U.S.-Controlled Corporations With Assets Equal to or Greater Than \$250 Million That Paid or Did Not Pay Income Taxes for 1989**

	Large foreign-controlled corporations (FCCs) that did not pay U.S. income tax		Large U.S.-controlled corporations (USCCs) that did not pay U.S. income tax	
		Percent of large FCCs		Percent of large USCCs
Returns	207	30	1,555	33
Receipts (million)	\$94,956	14	\$341,620	7
Assets (million)	\$243,226	21	\$1,904,803	15
	Large foreign-controlled corporations that paid U.S. income tax		Large U.S.-controlled corporations that paid U.S. income tax	
		Percent of large FCCs		Percent of large USCCs
Returns	486	70	3,095	67
Receipts (million)	\$584,329	86	\$4,705,449	93
Assets (million)	\$935,649	79	\$10,892,026	85
Taxes (million)	\$4,193	100	\$64,434	100

Note: Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.



We examined several categories of expenses and deductions claimed by corporations in 1989 and found that the ratio of cost of goods sold to receipts for foreign-controlled corporations was at least 12 percentage points higher than the same ratio for U.S.-controlled corporations. (See table 3.) Although data showing differences between foreign- and U.S.-controlled corporations could indicate potential transfer price abuse by foreign-controlled corporations, they do not prove such abuse. We concluded in our 1992 report that other factors, such as attempts to increase market share, newness of investment, extent of leverage, and fluctuating exchange rates can also contribute to the differences.

Table 3: Percentage of Cost of Goods Sold, Interest, and Net Operating Loss Deductions for Foreign- and U.S.-Controlled Corporations in 1989

	Foreign-controlled corporations		U.S.-controlled corporations	
	Did not pay tax	Paid tax	Did not pay tax	Paid tax
Cost of goods sold/receipts	69.9%	67.4%	55.2%	55.4%
Interest paid/receipts	9.2%	6.2%	8.2%	8.2%
Net operating loss deduction/receipts	0.2%	0.7%	0.5%	0.4%
Taxes/receipts	0.0%	0.8%	0.0%	1.3%

Note: Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.

IRS' EXPERIENCES WITH TRANSFER PRICING IN EXAMINATIONS, APPEALS, AND LITIGATION

IRS examiners continue to propose substantial section 482 adjustments to income. However, IRS appeals officers, who are charged with resolving tax controversies without litigation, continue to substantially reduce adjustments proposed by examiners. Further, IRS has been unsuccessful in litigating important section 482 cases in the courts.

IRS' Examination of Section 482 Issues

IRS uses audits to encourage corporations to comply with section 482 and detect those who do not. In the wake of congressional oversight of IRS' transfer pricing enforcement activities, IRS increased the number of international examiners by 19 percent, from 490 in fiscal year 1990 to 582 examiners in fiscal year 1992. At about the same time, IRS increased the audit rate for foreign-controlled corporations from 1.3 percent<sup>4</sup> to 3.5 percent--1,666 actual 1992 examinations of 47,000 corporations.<sup>5</sup>

The amount of proposed adjustments to income that IRS has identified in audits is in the billions of dollars. For example, in 1992, for cases with total proposed adjustments of \$20 million or more, IRS proposed section 482 adjustments of \$1 billion for foreign-controlled corporations and \$3.1 billion for U.S.-controlled corporations. (See table 4.)

Reliable breakouts of IRS examinations with proposed adjustments under \$20 million and their section 482 proposed adjustments were not available. Although we reported last year that a new system for capturing examination data was to be used for 1992, this system for capturing all examination findings is not yet in place. IRS' goal is to have it operational in fiscal year 1993.

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<sup>4</sup>IRS testified in 1990 that it planned to examine 600 of 45,000 corporations.

<sup>5</sup>The long-term trend for IRS audits of all corporations--both with and without international components--was generally downward in the 1980s. In 1980, the audit rate for all corporations was 6.5 percent. In 1991 the rate was 2.4 percent.

**Table 4: Proposed Section 482 Income Adjustments of Foreign- and U.S.-  
Controlled Corporations With \$20 Million or More of Total Proposed Adjustments**

Dollars in billions

	Foreign-controlled corporations		U.S.-controlled corporations		Total	
	Firms	Adjustment amount	Firms	Adjustment amount	Firms	Adjustment amount
1989	12	\$0.7	31	\$4.1	43	\$4.8
1990	11	\$1.6	26	\$4.4	37	\$6.0
1991	12	\$1.1	23	\$1.2	35	\$2.3
1992	13	\$1.0	37	\$3.1	50	\$4.1

Note: A few large adjustments significantly affect comparisons of adjustments for foreign- and U.S.-controlled corporations since they comprise large percentages of the totals.

Source: IRS data.

In trying to determine the amount of IRS staff time spent on section 482, we found that IRS does not have a system for capturing staff time used on individual Internal Revenue Code sections. Using a formula provided by IRS, however, we estimated that in fiscal year 1992, IRS spent about 19 economist staff years and 164 international examiner staff years on examinations that had a section 482 adjustment among other issues. The international examiner time was about 40 percent of international examiners' time spent on all closed international examinations.

We also found that for cases with proposed adjustments of \$20 million or more, 71 percent of international examination time went to cases with one or more section 482 issues in fiscal year 1992. According to an IRS analysis of these cases, which IRS cautioned is skewed by a few large cases and combined several types and sizes of taxpayers, it took over twice as many hours per year to examine a corporation with a section 482 issue as it did to examine one without the issue.

Section 482 cases resulted in more projected tax per hour of examination for U.S.-controlled corporations but less tax per examination hour for foreign-controlled corporations. In terms of projected tax divided by examination hours, audits of U.S.-controlled corporations with section 482 issues were twice as productive (\$25,766) as those without these issues (\$12,955). However, the productivity of audits of foreign-controlled corporations with section 482 issues (\$20,436) was less than those without section 482 issues (\$23,558).

In a related matter, an internal IRS report in mid-1991<sup>6</sup> and our 1992 report recommended that IRS implement a staffing model to better assess international staffing needs overall as well as on audits of other than the largest corporations. IRS has not yet implemented such a model but is studying how best to do it. Its goal for having the model in place is September 30, 1993.

It will be a while before the impact of the staffing model, the new system capturing examination data, and the continuing section 482 examination findings can be assessed. For example, the IRS Appeals Office's experience that I will describe next relates in great part to section 482 examinations done in previous years, and not to examinations recently completed.

#### Appeals Continues to Reduce Income Adjustments Proposed in Examinations

When adjustments or penalties are proposed in an examination of a return, the taxpayer can take the dispute to Appeals, which is the administrative body within IRS authorized to settle tax controversies. We found that IRS' experience with section 482 issues in Appeals has not improved. While IRS examiners continued to identify billions of dollars of proposed income changes in section 482 issues, IRS' appeals officials substantially reduced previous years' proposals.

#### Open Issues<sup>7</sup>

As of September 30, 1992, Appeals had 352 proposed section 482 adjustments worth \$14.4 billion, as opposed to the \$13.1 billion of outstanding adjustments as of April 30, 1991.<sup>8</sup> Of the \$14.4 billion of adjustments, \$2.4 billion were for foreign-controlled corporations. IRS reported that, as of September 30, 1991, one-third of all open international appeals dollars and one-tenth of all open appeals dollars were linked to section 482.

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<sup>6</sup>IRS, Strategic Initiative SVC-17, Positioning IRS for the Evolving International Economy: Issue Focus and Program Measurement, 1991.

<sup>7</sup>"Open" issues are issues referred to Appeals but not yet settled by appeals officers. "Closed" issues are issues where settlement has been reached.

<sup>8</sup>Appeals does not track every issue related to section 482 but believes it captures the large ones by focusing on the largest issues in cases that meet certain tax deficiency criteria.

## Closed Issues

We reported last year that 29 percent of section 482 proposed adjustments to income were sustained in IRS' appeals process in 1987 through 1989.<sup>9</sup> This number rose to 52 percent in 1990. In 1991 the sustention rate was 23 percent for foreign-controlled corporations, and it was 28 percent for U.S.-controlled corporations. However, in 1992 the sustention rate changed to 5 percent for foreign-controlled corporations and to 30 percent for U.S.-controlled corporations. According to IRS officials, the fluctuation in sustention rates for section 482 from year to year might be due to the resolution of a few cases with large dollar implications.

In fiscal year 1992, Appeals closed 163 transfer pricing cases. Examiners originally proposed a net income increase of \$1.9 billion, but Appeals officers reduced the adjustments by \$1.5 billion. As a result, Appeals sustained only 24 percent, or \$467 million, of the proposed adjustments. The majority of the 163 closed cases--138--involved U.S.-controlled corporations.

### Reasons for Reaching a Settlement in Appeals

In recent years, IRS began tracking the reasons why the appeals process reached a particular settlement in particular cases. According to Appeals data, the principal reason for reducing the adjustments in fiscal year 1992 was concern about whether the court would apply the same judgment to the evidence as IRS had. This reason accounted for 40 percent, or \$588 million, of the \$1.5 billion reduction in the original proposed income adjustments. As I will discuss in the following section, we found that IRS examiners in many audits exercised considerable subjective judgment to estimate arm's length prices in cases in which no comparable uncontrolled prices existed.

Two other reasons accounted for another 31 percent of the reduction. These were that (1) section 482 proposed adjustments were reduced because an alternative strategy for adjusting a taxpayer's income produced a better result for the government according to Appeals and (2) new facts or evidence were obtained and evaluated by Appeals or IRS' Chief Counsel.

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<sup>9</sup>The sustention rate is defined as the ratio of the adjustment amount determined after Appeals' settlement of an issue to the adjustment amount proposed by examiners. IRS heavily qualifies sustention rates because the data collected for 1987 through 1989 were not gathered to measure sustention rates.

IRS' Experience with Transfer Pricing Issues  
in the Courts Has Not Been Favorable

IRS' experience in the courts with section 482 has been disappointing. We identified all five corporations for which major section 482 cases had been decided by various courts between January 1, 1990, and December 31, 1992. These cases took an average of 14 years from the earliest tax year audited until the most recent resolution in the courts, and they involved both U.S.- and foreign-controlled corporations. The cases illustrate how disputes over section 482 issues can become extremely expensive for taxpayers and the government by requiring the employment of outside experts, resulting in long, drawn out litigation and keeping corporate tax liabilities in an uncertain status for years.

IRS lost a significant section 482 issue for each of the five corporations. For example, courts have found that IRS abused its discretion under section 482 and that IRS' reallocation of income was unwarranted or arbitrary, capricious, and unreasonable.

**Table 5: Summary of Corporations With Major Section 482 Court Cases Decided Between January 1, 1990, and December 31, 1992**

Name	Date of returns studied	Date of ruling	Tax amount at issue (in millions)	Winner and ruling
Bausch & Lomb, Inc.	1979-81	1991	\$9	Mixed--According to the appellate court, IRS' reallocation was unreasonable, and the Tax Court's reduction of the reallocation was appropriate, although some reallocation was permitted.
Merck & Co., Inc.	1975-76	1991	\$5	Taxpayer--IRS' reallocation of income was arbitrary, capricious, and unreasonable.
Sundstrand Corp. (2 cases)	1977-80	1991-2	\$50	Mixed--IRS abused discretion under section 482, and adjustments were unreasonable. Royalty was not arm's length. Taxpayer did owe some money. Issues decided in first case could not be relitigated.
Procter & Gamble Co.	1978-79	1992	\$2	Taxpayer--Section 482 allocation was unwarranted. According to the appellate court, income distortion resulted from Spanish law, not from control by the parent.
Westreco, Inc.	1978-82	1992	\$9	Taxpayer--IRS abused discretion; fees reflected income.

Note: We selected the five cases from Tax Notes indexes by picking those that were decided between January 1, 1990, and December 31, 1992, and involved what we considered to be a major section 482 reallocation issue.

Source: Tax Notes and court cases.

IRS' USE OF CERTAIN PROCEDURAL TOOLS  
HAS VARIED; THEIR ULTIMATE IMPACT IS  
STILL UNKNOWN

IRS has used certain new and existing procedural tools-- designated summonses, formal document requests, advance pricing agreements, additional penalties, simultaneous examinations, and arbitration--to varying degrees. For most of them, we found that it is too soon to tell what their impact will be.

Designated Summonses and Formal Document Requests

IRS issued three designated summonses for transfer pricing cases in fiscal years 1991 and 1992. Sanctioned by Congress in 1990, designated summonses are summonses issued by IRS to suspend the running of the statute of limitations governing the time IRS has for assessing additional taxes against a taxpayer. According to an IRS official, the low number issued is the result of taxpayers, under new record-keeping requirements, cooperating more in providing documentation to examiners, precluding the need for tougher enforcement action.

This is the same reason given for the drop in formal document requests issued by IRS. These requests are issued when relevant taxpayer documents are outside the United States. The number of requests issued to foreign- and U.S.-controlled corporations declined from 28 in fiscal year 1991 to 13 in fiscal year 1992.

Advance Pricing Agreements

Since we completed our report last year, IRS has gone farther down the road of advance pricing agreements, or agreements in which IRS approves ahead of time the methodology a taxpayer will use in setting transfer prices. As of March 5, 1993, IRS had completed 9 advance pricing agreements and was in negotiation on another 45 cases. These agreements are intended to reduce the contentiousness over transfer pricing that might have arisen with these companies and to save IRS audit time in future years. However, as IRS testified last year, if it reaches its goal of 75 advance pricing agreements per year, it will be spending 90,000 to 120,000 staff hours per year on them.

If the voluntary agreement covers only a small percentage of the taxpayers with international activity, the bulk of section 482 audits would still have to be made under possibly adverse, contentious conditions for IRS. If, however, the advance pricing agreements become extremely popular and cover a much larger number of taxpayers, IRS will have to adjust its resources to accommodate them.



### Additional Penalties

Section 6662 of the Internal Revenue Code--as modified in 1990--imposes substantial penalties on tax underpayments attributable to certain section 482 allocations that were substantially misstated. However, the penalties have not been used yet. According to the administration's revenue proposals,<sup>10</sup> this is due, in part, to the law not defining exclusions applying to taxpayers who acted in good faith and had reasonable cause for determining their transfer prices.

The administration's revenue proposals would amend section 6662(e) to define the reasonable cause and good faith exclusion. To meet the exclusion, the taxpayer would have to provide contemporaneous documentation showing the use of one or more reasonable transfer pricing methodologies on the taxpayer's controlled transactions.

According to the administration proposals, once the exclusion definition is enacted, compliance should improve. The substantial penalty will give taxpayers a strong incentive to apply and document a methodology leading to an arm's length result. Also, the administration believes that the documentation required would enhance examination effectiveness. Instead of devoting resources to identifying transfer pricing issues and developing comparable data to support a methodology, examiners would be able to focus immediately on the methodology's validity and on the taxpayer's supporting data.

### Simultaneous Examinations

In simultaneous examinations, the United States and another country at the same time examine related parties under their jurisdictions in an effort to promote international tax compliance and information exchange. Thirty-three of these examinations were proposed in fiscal years 1991 and 1992, a much higher number than that proposed in previous years. However, in those two fiscal years, only nine simultaneous examinations were accepted--all in 1992--for follow through.

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<sup>10</sup>Department of the Treasury, Summary of the Administration's Revenue Proposals (Feb. 1993).

For years, at least since our 1981 report on transfer pricing,<sup>11</sup> IRS has emphasized the importance of its simultaneous examination program to protect U.S. interests in international tax enforcement. However, according to IRS and foreign officials, problems such as differences in language and audit periods have existed and we believe these problems would keep the number of examinations relatively modest.

### Arbitration

In our June 15, 1992, report we stated that, according to IRS officials, Tax Court Rule 124, covering voluntary binding arbitration, had not yet been used much in general or in section 482 cases. Under this rule, any time a factual case is at issue and before trial, the parties to the case may move to resolve it through voluntary binding arbitration. IRS had begun promoting arbitration at the time of our report, but to date only one transfer pricing arbitration case has been scheduled. Other taxpayers may be awaiting the outcome of this case.

In summary, because of IRS' limited experience with such tools as arbitration, simultaneous examinations, substantial valuation penalties related to section 482, and advance pricing agreements, it is too soon to tell what their eventual impact will be.

### CHALLENGES OF SECTION 482 WILL CONTINUE

The challenges of section 482 cases will continue because the growing internationalization of the U.S. economy will increase the potential for underpayment of U.S. taxes through transfer pricing practices of multinational enterprises. In addition, the arm's length standard will continue to be difficult for IRS to enforce.

### Growing Internationalization of the U.S. Economy

The U.S. economy has been increasingly influenced by international forces in the last 30 years. This influence has been demonstrated by the growing amount of merchandise trade between affiliated corporations and our dependence on foreign trade and foreign investments. For example, merchandise exports of U.S. parent companies to their foreign affiliates increased from \$6 billion in 1966 to \$86 billion in 1989 and represented 24 percent of total U.S. merchandise exports in 1989. Merchandise imports by U.S. parent companies from their foreign affiliates increased from \$4 billion in 1966 to \$72 billion in 1989 and represented 15 percent of U.S. merchandise imports in 1989.

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<sup>11</sup>IRS Could Better Protect U.S. Tax Interests in Determining the Income of U.S. Multinational Corporations (GAO/GGD-81-81, Sept. 30, 1981).

The growing internationalization of the U.S. economy poses a major challenge for IRS because the potential for underpayment of U.S. taxes increases with the number of transactions done among affiliates of foreign- and U.S.-controlled multinationals. While we do not know the exact number of such transactions, we know that the number of affiliates has increased in recent years. For example, of the 7,500 largest foreign corporations controlled by U.S. corporations, an average of 237 firms per year were incorporated from 1980 through the first half of 1989. Also, the number of returns of foreign-controlled corporations increased 22 percent, from about 37,000 for the 1984-to-1986 period to about 45,000 returns for the period 1987 to 1989.

#### Problems That Have Existed With Arm's Length Pricing

As indicated in our June 1992 report, the arm's length standard requires that the price charged on a transaction between related corporations be the price that would have been charged if the corporations had been unrelated. To enforce this standard, IRS must analyze comparable transactions between unrelated corporations to identify an arm's length price that the related corporations must charge. If IRS finds a difference between the arm's length price and the price that the related corporations charge, it can propose an adjustment to the related corporations' income.

Under the current regulations, IRS and taxpayers use direct and indirect methods for identifying arm's length prices. The comparable uncontrolled price method is based on a direct comparison of the prices charged on readily identifiable, comparable transactions between unrelated parties. More indirect methods, such as the resale price, cost plus, and other appropriate methods, base prices on comparisons with unrelated corporations performing similar functions. All of these methods may require IRS examiners to use considerable judgment and to develop and analyze a great deal of data. The indirect methods require a greater degree of judgment and data analysis.

A major obstacle in enforcing the arm's length standard has been the difficulty that IRS examiners have had in finding readily identifiable, comparable transactions. In the absence of such comparables, they have relied on the more subjective, indirect methods to find transfer prices. Several studies, listed in table I.3 in appendix I, showed that these indirect methods were used for most section 482 cases. The data requirements and the subjective nature of the pricing methods imposed a significant administrative burden on both corporate taxpayers and IRS and created uncertainty for corporations about their ultimate tax liabilities.

## Impact of New Section 482 Regulations Is Uncertain

On January 21, 1993, IRS' temporary regulations on intercompany transfer pricing were published. The temporary regulations are for tax years beginning after April 21, 1993. The regulations provide guidance on the factors that need to be considered when determining appropriate comparable transactions, but the task itself remains based on facts and circumstances. The regulations may ease IRS' enforcement problems by requiring increased documentation of taxpayers' transfer pricing methods.

Also, the revised regulations provide more flexibility to taxpayers in selecting their transfer pricing methods. A new "best method" approach allows the method to be chosen that gives the most accurate result under the arm's length standard given the facts and circumstances of each transaction.

However, because the "best method" approach is based on the facts and circumstances of each case, the task of selecting and justifying transfer prices will remain complex and open to interpretation. As we said in our June 1992 report, transfer pricing problems will not be solved soon because of the fact-sensitive nature of the cases. Also, the difficulty of finding comparable transactions will remain for many intangible properties. The new regulations provide less guidance for transactions involving intangibles than for transactions involving other types of property.

On the positive side, the additional guidance on determining comparable transactions and the recognition that a range of prices rather than a single arm's length price may exist should reduce the uncertainty that taxpayers face under the current regulations. Taxpayers with prices within the arm's length range will be protected to some degree from small changes in transfer prices by IRS that result in large increases in tax liabilities. IRS may still make periodic adjustments to the charge for intangible property to meet the commensurate with income standard.<sup>12</sup>

Increased documentation requirements may also ease IRS' enforcement burden. The requirement for contemporaneous documented support for transfer pricing methods provides IRS with information for detecting abuse and evasion. The requirements may add to the compliance burden of taxpayers to the extent that transactions will be documented whether or not they are at issue

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<sup>12</sup>The Tax Reform Act of 1986 amended section 482 to require that payments for intangible properties transferred or licensed to related parties be "commensurate with the income attributable to the intangible."

with IRS. However, contemporaneous documentation will be useful to taxpayers in justifying their prices and in avoiding substantial misstatement penalties.

Although we expect problems with the arm's length standard to continue, we also recognize the difficulty of changing the standard. Because the arm's length standard is considered to be the international norm, any change would have to be coordinated with U.S. tax treaty partners in order to avoid double taxation of U.S. corporations. Such coordination is likely to be difficult and time-consuming.

In conclusion, although IRS has developed new regulations and begun to expand its use of certain tools for dealing with section 482 cases, we do not believe the end of the transfer pricing challenge is yet in sight. The problem is large in terms of the dollar amounts at stake, and the potential for underpayment of U.S. taxes is growing along with the growing internationalization of the U.S. economy. It is important, therefore, that IRS implement its managerial initiatives and continue to monitor the effectiveness of the regulations and its transfer pricing tools.

That concludes my statement. I would be pleased to respond to any questions.

**FOREIGN- AND U.S.-CONTROLLED CORPORATIONS  
THAT PAID OR DID NOT PAY U.S. INCOME TAX IN 1989**

**Table I.1: Foreign- and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989**

Distribution by asset size	Foreign-controlled corporations (FCC)		U.S.-controlled corporations (USCC)	
	Returns	Number	Percent of all FCCs	Number
Less than \$10 million	29,781	66.4	1,251,643	58.2
\$10 million under \$100 million	1,909	4.3	11,158	0.5
\$100 million under \$250 million	238	0.5	1,614	0.1
\$250 million or over	207	0.5	1,555	0.1
<b>Total</b>	<b>32,135</b>	<b>71.7</b>	<b>1,265,970</b>	<b>58.9</b>
Receipts	Millions	Percent of FCCs' receipts	Millions	Percent of USCCs' receipts
	Less than \$10 million	\$27,790	2.9	\$764,596
\$10 million under \$100 million	49,763	5.1	211,246	2.5
\$100 million under \$250 million	30,450	3.1	85,101	1.0
\$250 million or over	94,956	9.8	341,620	4.1
<b>Total</b>	<b>\$202,959</b>	<b>21.0</b>	<b>\$1,402,563</b>	<b>16.9</b>
Assets	Millions	Percent of FCCs' assets	Millions	Percent of USCCs' assets
	Less than \$10 million	\$27,022	1.9	\$335,114
\$10 million under \$100 million	56,099	3.9	339,521	2.2
\$100 million under \$250 million	38,530	2.6	252,339	1.7
\$250 million or over	243,226	17.0	1,904,803	12.5
<b>Total</b>	<b>\$362,878</b>	<b>25.4</b>	<b>\$2,831,776</b>	<b>18.5</b>

Note 1: Totals may not add due to rounding.

Note 2: Figures were obtained from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Source: IRS data.

Table I.2: Foreign- and U.S.-Controlled Corporations That Paid Income Taxes, 1989

Distribution by asset size	Foreign-controlled corporations (FCC)		U.S.-controlled corporations (USCC)	
	Number	Percent of all FCCs	Number	Percent of all USCCs
<b>Returns</b>				
Less than \$10 million	10,057	22.4	858,505	39.9
\$10 million under \$100 million	1,795	4.0	18,916	0.9
\$100 million under \$250 million	366	0.8	3,138	0.1
\$250 million or over	486	1.1	3,095	0.1
<b>Total</b>	<b>12,704</b>	<b>28.3</b>	<b>883,654</b>	<b>41.1</b>
<b>Receipts</b>	Millions	Percent of FCCs' receipts	Millions	Percent of USCCs' receipts
Less than \$10 million	\$31,283	3.2	\$1,230,622	14.8
\$10 million under \$100 million	81,896	8.5	621,793	7.5
\$100 million under \$250 million	66,653	6.9	335,044	4.0
\$250 million or over	584,329	60.4	4,705,449	56.7
<b>Total</b>	<b>\$764,162</b>	<b>79.0</b>	<b>\$6,892,907</b>	<b>83.1</b>
<b>Assets</b>	Millions	Percent of FCCs' assets	Millions	Percent of USCCs' assets
Less than \$10 million	\$14,471	1.0	\$446,326	2.9
\$10 million under \$100 million	58,284	4.1	624,661	4.1
\$100 million under \$250 million	57,869	4.0	487,149	3.2
\$250 million or over	935,649	65.5	10,892,026	71.3
<b>Total</b>	<b>\$1,066,272</b>	<b>74.6</b>	<b>\$12,450,164</b>	<b>81.5</b>

Distribution by asset size	Foreign-controlled corporations (FCC)		U.S.-controlled corporations (USCC)	
	Millions	Percent of FCCs' taxes	Millions	Percent of USCCs' taxes
Less than \$10 million	\$526	8.5	\$10,189	11.6
\$10 million under \$100 million	912	14.8	8,260	9.4
\$100 million under \$250 million	530	8.6	5,048	5.7
\$250 million or over	4,193	68.1	64,434	73.3
Total	\$6,161	100.0	\$87,931	100.0

Note 1: Totals may not add due to rounding.

Note 2: Figures were derived from weighted estimates based on samples, with weights provided by IRS, and they are subject to sampling error.

Note 3: Table provides information about companies that paid tax. Percentages reported in both tables are based on the total amount of returns, receipts, assets, and taxes paid by all corporations in each group.

Source: IRS data.



METHODS USED IN TRANSFER PRICING CASESTable I.3: Percentage of Cases in Which Various Section 482 Pricing Methods Were Used

Report or survey	CUP <sup>a</sup>	Resale	Cost plus	Other
1973 Treasury report	21%	11%	27%	41%
1972 Conference Board report	28%	13%	23%	36%
1980 Burns report	24%	14%	30%	32%
1981 GAO report (tangible property)	15%	12%	26%	47%
1984 IRS survey	41%	7%	7%	45%
1987 IRS survey (overall)	32%	8%	24%	36%
1987 IRS survey (tangible property)	31%	18%	37%	14%

<sup>a</sup>Comparable uncontrolled prices.

Sources: A Study of Intercompany Pricing (White Paper), Treasury Department (Oct. 18, 1988); and IRS Could Better Protect U.S. Tax Interests in Determining the Income of Multinational Corporations (GAO/GGD-81-81, Sept. 30, 1981).

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