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New Developments in Transfer Pricing Rules

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A CONSIDERATION OF SELECTED ISSUES RELATING TO UNITED STATES TAXATION OF INTERNATIONAL TRANSFERS OF INFORMATION AND OTHER INTELLECTUAL PROPERTY

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I. INTRODUCTION

The development of United States principles relating to the taxation of international transfers of information and other intellectual property has been steady, but problematic. The problems have been created by the conflicting needs of the United States and multinational businesses.[1] The goal of the United States tax authority is to impose and collect its share of the tax allocable to income derived by a business. In judging the pricing of transfers by related companies that operate across national borders, the United States is concerned that, because all income derived ultimately rests within the related group, prices set by group members may not be at arm's length and may be set in a manner designed to distort or minimize tax consequences. The component members of a multinational business desire advance warning of acceptable pricing methodology and assurance that all countries will treat operations consistently. In balancing those interests, three goals evolve. These goals are: (1) the adoption of a transfer pricing methodology that taxes an appropriate amount of profits and enables the multinational busi-

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1. For a discussion of problems encountered by taxing authorities and multinational businesses in connection with cross border transfers of property, see Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299; STAFF OF JOINT COMM. ON TAX'N, 101ST CONG., 1ST SESS., PRESENT LAW AND CERTAIN ISSUES RELATING TO TRANSFER PRICING (Code sec. 482) (Comm. Print 1990); ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES (1979); ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES: THREE TAXATION ISSUES (1984).

ness to predict the likely consequences of related group transactions; (2) the adoption of a methodology that is easy to implement and not costly; and (3) the commission of resources to international cooperation efforts in order to avoid the prospect of double taxation.

Considering those goals, this Article discusses generally current United States transfer pricing methodology, international cooperation, enforcement mechanisms, and related issues.

II. FUNDAMENTALS

A. *Operating Principles*

1. Code and Regulations

In the case of any transfer of property between commonly controlled businesses, the Internal Revenue Service (IRS or Service) possesses the power to allocate gross income between the parties involved "in order to prevent evasion of taxes or clearly to reflect the income of the businesses."[2] Since the enactment of the 1986 Tax Reform Act, when there is a transfer or license of intangible property, the Service's power to allocate gross income encompasses the authority to ensure that any income arising out of the transfer or license be "commensurate with income attributable to the intangible."[3] The term "intangible" includes a patent, invention, process, know-how, copyright, trademark, franchise, method, system, or technical data.[4] The "commensu-

2. I.R.C. § 482 (1990).

3. The Tax Reform Act of 1986 (1986 Tax Reform Act), Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2562, 2563 (1986) added the last sentence of section 482 of the Internal Revenue Code (Code), as follows:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. *In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.*

(emphasis added).

4. I.R.C. § 936(h)(3)(B) (1990). Treas. Reg. § 1.482-2(d)(3) (1990) provides substantially the same definition of intangible property. The regulations, promulgated before enactment of section 936(h), omit the term "know-how." *Id.* The intangible property must have substantial value independent of the services of any individual. I.R.C. §

rate with income" standard was added to the Internal Revenue Code (Code) to ensure that income derived from intangible property transfers from foreign affiliates to United States businesses (inbound transfers) and from United States affiliates to foreign businesses (outbound transfers) "reasonably reflect the relative economic activity undertaken by each."[5] The new standard was intended to curb transfers of intangibles to related foreign corporations in low tax jurisdictions that had resulted in inadequate allocations of income to entities subject to United States taxation.[6] It was also intended to hinder efforts by foreign owners of United States corporations to reduce the United States affiliates' taxable income by transferring property to the affiliates at unrealistically high prices.[7]

While the Code expresses no standard for the allocation of income among commonly controlled businesses, the regulations promulgated under section 482 of the Code indicate that a reallocation of income will place controlled taxpayers on a "tax parity" with uncontrolled taxpayers by determining the "true taxable income" from the property and business of the former.[8] In short, the regulations opt for the standard of "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[9] They accord the Service authority to make appropriate allocations if intangible property is transferred to a related party for other than "arm's length consideration."[10] Since they have

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936(h)(3)(B) (1990); Treas. Reg. § 1.482-2(d)(3) (1990).

5. H.R. CONF. REP. No. 841, 99th Cong., 2d Sess. II-637, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS 4725 [hereinafter H.R. CONF. REP. No. 841].

6. STAFF OF JOINT COMM. ON TAX'N, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 at 1013-14 (Comm. Print 1987) [hereinafter 1986 Bluebook].

7. H.R. CONF. REP. No. 841, *supra* note 5, at 637-68, *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS at 4725-26. Congress also reacted to the problem of manipulation by foreign owners of United States corporations by enhancing existing information reporting requirements. *See* 1986 Bluebook, *supra* note 6, at 1053. For further discussion of selected information reporting provisions, see *infra* notes 176-224 and accompanying text.

8. Treas. Reg. § 1.482-1(b)(1) (1990). The Internal Revenue Service's (Service) authority is not restricted to cases of fraudulent or sham transactions. Consequently, it extends to any case in which the taxable income of a controlled taxpayer is other than it would have been if the taxpayer had conducted its business as an independent taxpayer dealing with another independent taxpayer. Treas. Reg. § 1.482-1(c) (1990).

9. Treas. Reg. § 1.482-1(c) (1990).

10. Treas. Reg. § 1.482-1(d)(1) (1990). Where there is a transfer of intangible property an arm's length consideration may take any form that would result from a transaction negotiated by unrelated parties: a royalty, a lump sum payment or reciprocal licensing rights. Treas. Reg. § 1.482-2(d)(2)(i) (1990). Where the transferee pays nominal

not been modified to reflect the 1986 amendment, the regulations do not reconcile the "commensurate with income" and "arm's length" standards.

The best measure of an arm's length consideration for a transfer of an intangible item is the amount that would have been paid by an unrelated party for the same or similar intangible under the same or similar circumstances.[11] Where there are no similar transactions with unrelated parties, the regulations refer to numerous factors that may aid in the determination of an arm's length price.[12] The factors include prevailing rates in the industry, offers of competitors, uniqueness of the property, the nature of protection afforded the property under pertinent laws, costs incurred in developing the property, and arm's length prices on resale or sublicense of the property.[13] Because no factor is more significant than another, the regulations fail to provide guidance for an appropriate pricing approach where comparable transactions with unrelated parties do not exist.[14] Consequently, courts attempting to determine the adequacy of a taxpayer's pricing method have adopted a so-called "fourth method" — that is, some method not described in the regulations — when comparables are not available.[15]

2. Treasury Study

In an effort to clarify the post-1986 standard for determining prices for transfers of intangible property, the United States Treasury Department (Treasury) issued a "White Paper" in October 1988 entitled, "A Study of Intercompany Pricing under

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consideration and the transferor retains a substantial interest in the property, a lump sum payment is presumed not to be arm's length. *Id.*

11. Treas. Reg. § 1.482-2(d)(2)(ii) (1990).

12. Treas. Reg. § 1.482-2(d)(2)(iii) (1990).

13. Treas. Reg. § 1.482-2(d)(2)(iii) (1990). Other factors to be considered include: the terms of the transfer, the value of services rendered by the transferor in connection with the transfer, prospective profits to be realized, capital investment and start-up requirements of the transferee, and any other circumstance which unrelated parties would consider in determining the amount of arm's length consideration for the property. *Id.*

14. *A Study of Intercompany Pricing under Section 482 of the Code*, I.R.S. Notice 88-123, 1988-2 C.B. 458, 463, 466, 487 [hereinafter The White Paper].

15. The White Paper, *supra* note 14, at 468-69. *See* Treas. Reg. § 1.482-2(e)(1)(iii) (1990). While the regulations specify the fourth method only for cases involving transfer of tangible property, a similar method has been employed in intangibles cases in which there were no comparable or sufficiently similar transactions. *See, e.g.*, Bausch & Lomb, Inc. v. CIR, 92 T.C. 525, 600 (1989).

Section 482 of the Code."[16] According to the Treasury, the "goal of the [new] commensurate with income standard is . . . to ensure that each party earns the income or return from the intangible that an unrelated party would earn in an arm's length transfer of the intangible."[17] Further, it is the Treasury's view that the "correct application of the commensurate with income standard is premised soundly on arm's length principles."[18] Negotiated solutions are recommended where implementation of the commensurate with income standard proves to be inconsistent with the approach taken by United States treaty partners.[19]

The White Paper adopts a market-based approach to pricing arrangements between related parties.[20] The Treasury's ap-

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16. The White Paper, *supra* note 14. With the 1986 Tax Reform Act, Congress called for "a comprehensive study of intercompany pricing rules by the Internal Revenue Service" and provided that "consideration should be given to whether the existing regulations could be modified in any respect." 1986 Bluebook, *supra* note 6, at 1017.

17. The White Paper, *supra* note 14, at 472. The standard applies to lump sum sales and licenses as well as to contingent price licenses of intangibles. *Id.* at 472, 473, 479. Periodic review of lump sum transfers of intangibles is contemplated. *Id.* at 479. Transfers of intangible property in transactions described in section 351 (transfers of property to controlled corporations in exchange for stock) and section 361 (transfers of property in connection with corporate reorganizations) are governed by section 367(d). *See* Temp. Treas. Reg. § 1.367(d)-1T(g)(4)(i) (1986). For a description of section 367(d) requirements, see *infra* notes 92-99 and accompanying text.

18. The White Paper, *supra* note 14, at 472. The White Paper further states:

> Rather than creating a new class of royalty arrangements, the enactment of the commensurate with income standard reflects the recognition that, for certain classes of intangibles (notably high profit potential intangibles for which comparables do not exist), the use of inappropriate comparables had failed to produce results consistent with the arm's length standard.

Id. at 473. The drafters indicated that the White Paper is consistent with the view that the post-1986 version of section 482 was not intended as a departure from the arm's length standard. *Id.* at 475. *See generally id.* at 475-77 (discussing the arm's length standard as the international norm and the compatibility of the commensurate with income standard).

19. The White Paper, *supra* note 14, at 476. The United States Treasury Department (Treasury) maintains that the commensurate with income and arm's length standards are compatible, but acknowledges that inconsistencies may arise out of implementation (such as periodic adjustments) of the former. *Id.*

20. The White Paper, *supra* note 14, at 483. It has been argued that the arm's length approach fails to account for cost efficiency that may result when an integrated economic activity engages in a transaction. *Id.* It has also been suggested that related party transactions should not be governed by an arm's length standard because related parties do not conduct their affairs in the same manner as unrelated parties subject to market forces. *See generally id.* at 483-85. The White Paper rejects those arguments on the ground that greatest production efficiency will result if taxation rules do not encourage one form of business organization (the related enterprise) over another (the enterprise conducted by unrelated parties) by reducing the tax burdens of the former. Consequently, according to the Service, returns in related party transactions should be

proach assumes an equality between revenues and the sum of returns to each factor of production in a competitive industry where factors of production are competitive and mobile. Income to be attributed to related parties is derived by measuring the factors of production and computing the returns that each one would earn on its best alternative use in the marketplace. This approach is described by the Treasury as a corollary to the traditional arm's length method. The traditional approach looks at the prices that an enterprise would command in the marketplace, while the corollary — or alternative approach — determines the returns an enterprise would earn in the marketplace. The Treasury believes that "both approaches are equally consistent with the . . . goal of the arm's length principle, which is to use information about unrelated parties operating at arm's length to determine the allocation of income in a related party setting."[21] One of the most controversial aspects of the two approaches, discussed more fully below, is the recommendation for periodic or annual review of transfer prices obtained under either standard.[22]

The White Paper proposes two methods for implementing the arm's length standard.[23] One method relies on comparable transactions. The other employs the arm's length return method.

"Exact comparables" — that is, transactions involving the transfer of the same intangible property — are deemed the best

identical to those that would result if unrelated parties were engaged in the transaction. Therefore, income assigned to related parties in transfers should be the same that an unrelated party would earn in the same transaction (as though the unrelated party were using the more efficient cost structure of the related enterprise). *Id.*

21. The Treasury concedes that the alternative to the traditional approach may not suffice in situations in which a hypothetical unrelated party, as well as the related party in question, occupies a monopoly position in the marketplace. The White Paper, *supra* note 14, at 484-85. Moreover, the alternative procedure may be impossible to implement where more than one related party in an enterprise uses significant intangibles that are difficult to value. *Id.* at 485.

22. *See infra* notes 30, 36, 47-48 and accompanying text. Periodic review of lump sum arrangements is also contemplated. Under the approach suggested by the Treasury, the lump sum payment would be treated as a prepayment (a hypothetical certificate of deposit bearing interest at the applicable federal rate) of commensurate with income amounts. *See* The White Paper, *supra* note 14, at 479-80.

23. Both methods must account for the risk to be borne in the related party transactions. For example, a comparable transaction of an unrelated party is no measure of an arm's length price in a related party situation if the economic risk undertaken in one type of transaction is unlike that taken on in the other. Similarly, the degree of risk appropriately assumed by a related party must be considered in the arm's length return determination. *See* The White Paper, *supra* note 14, at 491-92.

evidence of what unrelated parties would do in a related party transaction.[24] The use of "inexact comparables" — transactions involving different but economically similar intangible property — may also be appropriate.[25]

A transaction that constitutes an exact comparable involves the same intangible property transferred under substantially similar circumstances.[26] In addition, "external" and "internal" indicia of the transactions must be substantially similar. External factors reflect the economic environment of the transactions. Among the external factors to consider are size and level of development of the markets, the existence of collateral transactions between the parties,[27] and the level of economic risks being assumed.[28] Internal factors reflect the contractual features of the transactions. Among the internal factors are the amount and form of compensation for the intangible and collateral agreements affecting the transferee.[29]

An exact comparable may become dissimilar over time. Periodic scrutiny may result in rejection of the comparable unless (1) the comparable contains substantially similar provisions for adjustments and (2) related parties actually make the adjustments that unrelated parties would make under comparable circumstances. In scrutinizing an exact comparable, the Treasury requires only that long-term results be comparable. Year-to-year equality is not required.[30]

If exact comparables are unavailable it may be appropriate to resort to inexact comparables.[31] An inexact comparable may

24. The White Paper, *supra* note 14, at 485. Exact comparables may exist for common as well as unique intangible property. *Id.*

25. The White Paper, *supra* note 14, at 485.

26. The White Paper, *supra* note 14, at 486. *See also* the criteria set forth in Treas. Reg. § 1.482-2(d) (1990). The transaction need not be in the same geographic market. The White Paper, *supra* note 14, at 486.

27. The White Paper, *supra* note 14, at 486. For example, an isolated transfer would not be comparable to a transfer in a continuing relationship.

28. The White Paper, *supra* note 14, at 486. For example, a transaction in which the transferee merely manufactures the intangible would not be comparable to one in which the transferee manufactures and markets the intangible. *Id.*

29. The White Paper, *supra* note 14, at 486. For example, if decelerator and accelerator clauses exist then they must appear in both transactions. Internal consistency would not exist if one agreement required the licensee to perform marketing and product development and the other provided for marketing by the licensor. *Id.*

30. The White Paper, *supra* note 14, at 486-87.

31. Inexact comparables may be used only when exact comparables do not exist. The White Paper, *supra* note 14, at 487. In some cases, it may be more appropriate to use the basic arm's length return method than an inexact comparable. *Id.* at 488. Exam-

be used if "the differences between it and the related party transaction can be reflected by a reasonable number of adjustments that have definite and ascertainable effects on the terms of the arrangement."[32] Comparisons may be made on the basis of factors listed in the current section 482 regulations relating to intangibles, with adjustments to reflect concerns raised in the 1986 amendments to section 482.[33] Appropriate inexact comparables may also be chosen on the basis of "functional analysis," currently employed by IRS auditors in certain transfer pricing situations. Functional analysis identifies the economic activities undertaken or to be undertaken in the future by the parties in the two situations to be compared.[34] The most appropriate inexact comparables are chosen from those situations in which the parties undertake the same major economic activities.[35]

As in the case of exact comparables, periodic scrutiny of an

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ples concerning the priority and coordination of the comparables and arm's length return methods are provided. *Id.* at 491. Appendix E of the White Paper provides 14 examples of the appropriate application of transfer pricing methodology. *Id.* at 528-34.

32. The White Paper, *supra* note 14, at 487. Here the Treasury recommends extending to transfers of intangible property current section 482 regulations regarding transfers of tangible property that permit reference to unrelated party sales (sales in which at least one party is unrelated) if:

> the physical property and circumstances involved in the [unrelated party] sales are identical to the physical property and circumstances involved in the [related] party sales, or if such property or circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price.

Treas. Reg. § 1.482-2(e)(2)(ii) (1990). In the intangibles area, a difference may be indefinite and unascertainable where, for example, the licensee in one transaction performs different functions than the licensee in the other (for example, substantial marketing activities). The White Paper, *supra* note 14, at 487. In addition, a difference in the fundamental profitability (for example, low-profit vs. high-profit) of the intangibles involved would render comparison inappropriate. *Id.*

33. The White Paper, *supra* note 14, at 487. The list, set forth in Treas. Reg. § 1.482-2(d)(2)(iii) (1990) includes prevailing industry rates, a factor which the Treasury feels would be properly examined only if the intangible in question is "demonstrably average." *Id.* In addition, the Treasury believes that, after 1986, prospective profits to be realized from the intangible should be given special consideration. The current regulations fail to accord special weight to prospective profits. *Id.* For a discussion of the view that the current intangibles regulations under section 482 are not useful because they fail to accord relative weight to the 12 factors listed, see The White Paper, *supra* note 14.

34. The White Paper, *supra* note 14, at 487. Functional analysis is also a part of the basic arm's length return method. *See infra* notes 37-50.

35. The White Paper, *supra* note 14, at 487.

inexact comparable may result in rejection of the comparable as a valid indicator of an appropriate transfer price in later periods. If later circumstances demonstrate the dissimilarity of an inexact comparable, the arm's length return method must be used to justify the transfer price in a related party arrangement.[36]

The Treasury anticipates that the basic arm's length return method (BALRM) will be used in situations in which there are no exact or inexact comparables from unrelated party transactions. A typical arrangement calling for application of the BALRM described in the White Paper is the so-called "round trip" transfer pricing situation. It involves licensing by a United States company of patent rights to new technology and sales of manufacturing components to a foreign affiliate that manufactures the technology, using components purchased from the United States affiliate and from other parties, and sells them to the United States affiliate. The United States affiliate markets and distributes the products. The BALRM approach examines the round-trip arrangement by identifying assets and other factors of production used by the related parties in their respective businesses and assigning market returns to them.[37]

The BALRM first employs functional analysis to determine the component activities or functions of each line of business. Functional analysis permits identification of the functions that can be measured and assigned a market return. Measurable factors are identified because of the wide availability of information from unrelated parties concerning market returns earned by them. Labor, plant equipment, working capital, and routine manufacturing intangibles[38] constitute measurable factors. Assets that are difficult to measure generally include significant preexisting intangibles and nonroutine intangibles.[39]

In the round-trip arrangement described above, the foreign manufacturing affiliate utilizes measurable factors of production — labor, plant equipment, working capital, and routine manufacturing know-how — while the United States licensing and

36. The White Paper, *supra* note 14, at 487-88.

37. The White Paper, *supra* note 14, at 488.

38. As an example of a routine marketing intangible the White Paper identifies "know-how related to efficiency in routine manufacturing processes that most manufacturers develop through experience." The White Paper, *supra* note 14, at 488.

39. The White Paper, *supra* note 14, at 488. Examples of nonroutine intangibles are the ongoing enterprise value of a research and development staff, marketing intangibles, and a patent concerning new technology. *Id.*

marketing company that owns the patent employs a research staff and marketing intangibles, assets that are difficult to measure. The BALRM assigns an arm's length return — consistent with the returns of unrelated parties — to each of the functions of the foreign affiliate.[40] The balance, or residual income, is allocated to the United States company.

The Treasury expects the BALRM to be widely applicable in situations involving most manufacturing affiliates and many distribution and marketing affiliates because they typically employ routine going concern and know-how intangibles possessed by many unrelated parties.[41] It may be inappropriate, however, to employ the BALRM in a number of situations. Primarily, the BALRM is not useful in situations involving foreign affiliates that perform complex functions, take significant risks, and own significant intangibles because of the dearth of unrelated party information (comparables or rates of return). In those situations, the BALRM plus profit split approach (BALRM plus method) must be used.

An example of an arrangement governed by the BALRM plus method is that of a United States parent company that licenses designs for producing educational toys to a foreign affiliate that makes minor adjustments to the designs, manufactures the designs through contract manufacturers, and utilizes its own trademark in marketing and distributing the products.[42] Under the BALRM plus method, each party is allocated a return on the functions performed. This is done first by identifying the functions performed by each in the line of business in which the designs are used. Functions that employ measurable factors are segregated. Assets employed in those functions are allocated an arm's length rate of return under the BALRM, and resulting income is attributed to the party performing the function.[43]

In order to allocate remaining income and to account for ac-

40. The White Paper, *supra* note 14, at 489. Information permitting a determination of an arm's length return is gathered by reference to rates of return on assets used in a particular function for unrelated parties. In the alternative, arm's length information may be determined by making other comparisons, such as the ratio of income to operating costs. *Id.* (citing E.I. DuPont deNemours & Co. v. U.S., 608 F.2d 445 (Ct. Cl. 1979), *cert. denied*, 445 U.S. 962 (1980)). Alternative methods may be helpful in measuring returns on service activities and in other situations where consistent measurement is difficult. *Id.*

41. The White Paper, *supra* note 14, at 489-90.

42. The White Paper, *supra* note 14, at 490.

43. The White Paper, *supra* note 14, at 490.

tivities involving significant intangible assets, intangible income attributable to the line of business is identified and split according to the relative value that the market would place on each party's significant intangibles if they were employed by unrelated parties.[44] The intangible income is equal to the balance of all net income from the line of business in which the designs are used (combining the parent and affiliate) after subtraction of the income allocated under the BALRM by attributing a rate of return to measurable factors. Such income is split between the related parties in accordance with the relative value of their intangibles.[45] The manner of splitting intangible income is largely a matter of judgment unless it is possible to uncover information concerning profit splits between unrelated parties in similar activities involving similar intangibles[46] or there is some evidence (for example, a recent purchase of an affiliate) of the value of the parent's or affiliate's intangibles.[47]

As in the case of comparable transactions, periodic adjustment will be made under the BALRM and the BALRM plus method to reflect changes in factors of production.[48] Only significant changes in income will trigger a periodic adjustment. Moreover, consistent with the rules for exact and inexact comparables, only long run, not year-to-year, equality in result between related party income and "ideal" application of the arm's length method is required.[49]

The study indicates that the rules governing transfer of intangible property will control transactions that also include provision of services and transfers of tangible property, situations that are normally governed by separate rules under the current section 482 regulations.[50] The rules relating to intangible prop-

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44. The White Paper, *supra* note 14, at 490.

45. The White Paper, *supra* note 14, at 490. Attribution of a specific value to each party's intangibles is not required. *Id.*

46. The White Paper, *supra* note 14, at 490. The White Paper incorporates the standard discussed in the text for determining appropriate inexact comparables. *See supra* notes 31-36 and accompanying text.

47. The White Paper, *supra* note 14, at 490-91.

48. The White Paper, *supra* note 14, at 491. The Treasury believes that periodic adjustment will be easier under the arm's length return method because either the basic or basic plus profit methods are determined by identifying factors of production and significant intangibles. As the value of the factors and significant intangibles changes, the method need only substitute new figures. *Id.*

49. The White Paper, *supra* note 14, at 491. *See also supra* note 30 and accompanying text.

50. The White Paper, *supra* note 14, at 492. *See* Treas. Reg. § 1.482-2(b), (e) (1990).

erty transfers are to govern in order to preclude restructuring of transactions by taxpayers who seek to take advantage of or to avoid the more or less favorable separate rules.[51]

3. Cost Sharing

A cost sharing arrangement is "an agreement between two or more persons to share the costs and risks of research and development as they are incurred in exchange for a specified interest in any property that is developed."[52] The current regulations permit cost sharing arrangements between related parties if they are *bona fide*.[53] A *bona fide* arrangement is written and reflects a good faith effort by participating members to bear their respective shares of all costs and risks on an arm's length basis.[54] An arm's length arrangement is comparable to one that would have been adopted by similarly situated unrelated parties.[55]

If there is no *bona fide* cost sharing arrangement, a section 482 adjustment may be made if the developer[56] transfers an interest in the intangible property developed to a related party for a non-arm's length price.[57] A transfer is deemed to occur whenever a related party, other than the developer, acquires an interest, such as a patent or copyright, in the developed property.[58] If a related party assists the developer by providing loans, services, or the use of tangible or intangible property, appropriate section 482 adjustments may be made in accordance with the rules governing transfers of that type.[59]

In view of the 1986 changes to section 482, the Treasury is considering ways in which to ensure that cost sharing arrange-

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51. The White Paper, *supra* note 14, at 492.
52. The White Paper, *supra* note 14, at 493.
53. Treas. Reg. § 1.482-2(d)(4) (1990).
54. *Id.*
55. *Id.*
56. The determination of the developer among a group of related businesses must be based upon all the facts and circumstances. Treas. Reg. § 1.482-2(d)(1)(ii)(c) (1990). Greatest weight is to be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the members of the related group. A member is not considered to bear the risks and costs of development unless they are borne without regard to the success of the project. *Id.*
57. Treas. Reg. § 1.482-2(d)(1)(ii)(a) (1990).
58. *Id.*
59. Treas. Reg. § 1.482-2(d)(1)(ii)(b) (1990). Those rules are contained in sections 1.482-2(a)-(c), (e). Consistent with statements in the White Paper, new rules may provide for priority of the standard for intangibles transfers. *See supra* notes 50-51 and accompanying text.

ments will be truly reflective of the "commensurate with income" standard. One matter of concern is the appropriate product area for the arrangement. In general, the Treasury has indicated that a broad product area, as reflected by the three-digit Standard Industry Code product areas, must be employed.[60] Thus, the cost sharing arrangement will be required to cover all research and development projects in a product area. The Treasury finds this approach necessary to prevent selective arrangements with related parties located in tax haven and low tax jurisdictions involving single high profit potential intangibles. The intent of the requirement of a broad product area is to provide for cost sharing by all related group members in the case of low profit potential intangibles and unsuccessful research as well as in the case of high profit potential intangibles.[61]

An additional concern of the Treasury is that costs borne under the arrangement be proportionate to the reasonably anticipated benefits to be received over time by each participant from exploiting the developed intangibles.[62] The Treasury believes that an accurate prediction of anticipated benefits is difficult unless exclusive geographic rights to intangibles developed under the arrangement are assigned. The alternative of assigning rights to different types of intangibles is considered an improper subject for a cost sharing arrangement.[63]

Moreover, the Treasury believes that a participant cannot expect to derive a benefit from an intangible, and consequently should not bear costs under a cost sharing arrangement, unless the participant will be capable of manufacturing the product when it is developed.[64] In addition, because cost shares should be determined on the basis of benefits to be derived, the addition of the "commensurate with income" standard in the 1986 amendment of section 482 requires that the arrangement "be

60. The White Paper, *supra* note 14, at 495.

61. The Treasury notes, however, that a product area that is broader or narrower than the three-digit Standard Industry Codes may be necessary to avoid disproportionate bearing of research and development costs by a United States group member. The White Paper, *supra* note 14, at 495.

62. The White Paper, *supra* note 14, at 495.

63. The White Paper, *supra* note 14, at 496. For example, the agreement could assign rights to manufacturing intangibles relating to products to be sold in the United States to the United States affiliate and rights related to European markets to an Irish affiliate.

64. The White Paper, *supra* note 14, at 496. For example, the cost sharing arrangement would be invalid if it assigned to the participants exclusive worldwide rights to different types of intangibles developed.

adjusted periodically, on a prospective basis, to reflect changes in the estimates of relative benefits."[65]

A "buy-in" payment is required whenever a party incurs costs or risk for developing an intangible before the cost sharing arrangement with other participants is in place. In order to determine an appropriate buy-in payment, the parties are required to value the incompletely developed intangible.[66] The buy-in payment must reflect fair market value and not cost.[67] A "buy-out" payment, one made to a withdrawing participant, must also be calculated to compensate for the fair market value of whatever the arrangement had produced at the time of withdrawal. Based on its belief that fully developed intangibles are not appropriate subjects for cost sharing arrangements, the Treasury indicates that royalties for such intangibles are subject to the normal section 482 "commensurate with income" rules.[68]

Because costs in developing marketing intangibles are accounted for amply under the section 482 services regulations, the Treasury feels that such intangibles are not appropriate subjects for cost sharing arrangements.[69]

B. Income Source Rules

1. Sales and Licenses of Intangibles

The United States rules for determining the geographical source of income (either United States source or foreign source) are contained in subchapter N of Chapter 1 of the Internal Revenue Code. As United States citizens, corporations, and residents (United States taxpayers) generally are taxed on worldwide income,[70] whether United States source or foreign source, the source rules are only significant for United States taxpayers because they determine the limitation on allowable foreign tax

65. The White Paper, *supra* note 14, at 496.

66. The valuation requirement will apply to preexisting intangibles in various stages of development, basic research not associated with a product, and going concern value arising from a participant's research facilities. The White Paper, *supra* note 14, at 497.

67. Secondary buy-ins, in which a new member is admitted after the cost sharing agreement commences, are subject to the same rules. If a new member obtains a portion of the geographic rights of another, the latter should receive the buy-in payment. The White Paper, *supra* note 14, at 497.

68. The White Paper, *supra* note 14, at 497.

69. The White Paper, *supra* note 14, at 497.

70. B. BITTKER & L. LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION 65-2 (1991) [hereinafter B. BITTKER & L. LOKKEN].

credit.[71] The credit against United States income tax liability allowable to United States taxpayers for income taxes paid to foreign countries is limited to a tax computed at the United States rates on foreign source income.[72] The limitation ensures that the United States does not subsidize tax rates imposed by foreign governments that are higher than the top United States rate.[73]

For foreign taxpayers (taxpayers other than United States taxpayers), the geographical rules governing source of income are significant because they generally mark the limit of United States income tax jurisdiction. Nonresident aliens and foreign corporations must pay federal income tax on United States source income and upon income of any source that is effectively connected with the conduct of a United States trade or business.[74] Detailed rules determine whether income is effectively connected.[75] In general, the rules make it more difficult to connect foreign source income to the conduct of a United States trade or business.[76]

Royalties from property located in the United States and royalties for the use or the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property are treated as United States source income.[77] All other royalties are treated as having a foreign source.[78] For sales of intangible property in which payment is contingent on the

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71. B. BITTKER & L. LOKKEN, *supra* note 70, at 69-4.

72. Under section 904(a) of the Code, the credit for foreign income taxes paid or incurred is limited to the following amount:

$$\text{United States tax on worldwide taxable income} \times \frac{\text{foreign source taxable income}}{\text{worldwide taxable income}}$$

B. BITTKER & L. LOKKEN, *supra* note 70, at 69-37.

73. Such a subsidy would result if the United States allowed a credit for the full amount of tax imposed at the higher rates by the foreign government. By allowing a credit for the full amount, the United States would cede its own taxing jurisdiction in favor of that of the foreign country. The credit would offset United States tax on the same income taxed by the foreign government and would also reduce United States tax on other income, including income from United States sources. For an example of the operation of the foreign tax credit limitation when the income tax rate of the foreign country is higher than the United States rate, see B. BITTKER & L. LOKKEN, *supra* note 70, at 69-4.

74. I.R.C. §§ 872(a), 882(b) (1990).

75. I.R.C. § 864(c) (1990); Treas. Regs. § 1.864-3 to § 1.864-7 (1990). *See generally* Dale, *Effectively Connected Income*, 42 TAX L. REV. 689 (1987).

76. *Compare* I.R.C. § 864(c)(2)-(3) (1990) *with* I.R.C. §§ 864(c)(4), 865(e) (1990).

77. I.R.C. § 861(a)(4) (1990).

78. I.R.C. § 862(a)(4) (1990).

productivity, use or disposition of the intangible, the source rule is the same as that for royalties.[79]

If intangible property is sold for a lump sum or under any other arrangement in which payment is not contingent on the productivity, use or disposition of the intangible, the source of income derived from the sale is based upon the residence of the seller. Foreign source income is income derived from all such sales other than those made by United States residents.[80] In some instances, these rules are altered when the income is attributable to an office (or other fixed place of business). For a United States resident, income from a lump sum sale (but not a license or a contingent price sale) of an intangible is treated as having a foreign source if the income is attributable to a fixed place of business of the resident maintained in a foreign country and a foreign country imposes a tax of at least ten percent.[81] In general, for a foreign resident, income attributable to a United States office that arises from any form of transfer of intangible property is treated as having a United States source. There is an exception relating to a sale of inventory property sold for use outside the United States if a foreign office materially participated in the sale.[82] Under special rules for intangibles (and certain other property not here relevant) available at the election of the taxpayer, United States source gain (as determined under the normal rules of section 865 described above) from the sale of an intangible is treated as foreign source income if a United States tax treaty treats such income as foreign source.[83]

2. Research and Development

Research and development (R & D) costs incurred in connection with the development of an intangible are generally deductible as a current expense under section 174 of the Code.[84]

79. I.R.C. § 865(d)(1)(B) (1990). For a discussion of the distinction made in tax law between a sale and a license of intangible property, see Lokken, *The Sources of Income From International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 233, 245-69 (1981).

80. I.R.C. § 865(a), (d) (1990). The term "United States resident" has a special definition for purposes of section 865. I.R.C. § 865(g) (1990).

81. I.R.C. § 865(e)(1) (1990).

82. I.R.C. § 865(e)(2)(A), (B) (1990).

83. I.R.C. § 865(h)(1), (2)(A), (1990). Such gain is placed in a separate category for purposes of the foreign tax credit limitations. I.R.C. § 865(h)(1)(B) (1990).

84. I.R.C. § 174 (1990) allows as a deduction research and experimental expenditures paid or incurred in connection with a taxpayer's trade or business. The taxpayer

Where the operations of a United States taxpayer generate income from United States and foreign sources, detailed rules require that the R & D expenditures be allocated partly to United States source and partly to foreign source income.[85] The current rules provide for the allocation and apportionment of more expenditures related to United States based R & D activities to United States source gross income, as requested by United States taxpayers. The request was made because the old rules often created a situation in which United States taxpayers were unable to obtain a credit against United States tax liability for income taxes paid to a foreign country that did not permit a deduction against income within its taxing jurisdiction of R & D expenditures attributable to activities conducted in the United States. For United States foreign tax credit limitation purposes, under the old rules a greater portion of the United States based R & D expenses was allocated to foreign source gross income and resulted in a lower foreign source taxable income upon which the foreign tax credit limitation, described above, could be determined. United States taxpayers contended that the double taxation resulting from the payment of foreign taxes for which no credit against United States tax liability was available discouraged the performance of R & D activities in the United States. A concern that United States tax laws were anticompetitive led to a moratorium on the existing regulations, an end to that moratorium under the 1986 Tax Reform Act, and the enactment of temporary solutions that may be precursors of new permanent rules that will provide for a greater allocation of United States based R & D expenses to United States source gross income.[86]

The rules applicable for a taxpayer's first taxable year beginning after August 1, 1987 (post-1987 rules) provide for a sixty-four percent-thirty-six percent allocation of expenses. The sixty-four percent of expenditures is apportioned automatically to the location of the research activities. For R & D expenditures attributable to activities conducted in the United States, sixty-four percent of those expenditures is allocated and apportioned to income from United States sources. For such expenditures attributable to activities conducted outside the United States,

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has an option under section 174(b) to amortize such expenditures over a 60 month period.

85. I.R.C. § 864(f) (1990); Treas. Reg. § 1.861-8(e) (1990).

86. For a discussion of the history of the current rules, see B. BITTKER & L. LOKKEN, *supra* note 70, at 70-48.

sixty-four percent is allocated and apportioned to income from foreign sources. The balance may be apportioned under a gross sales or gross income method. If the taxpayer elects to apportion on the basis of gross income, the amount of expenses apportioned to foreign source income must be at least thirty percent of the amount that would be so apportioned under the gross sales method.[87] Any R & D expenditures made solely to meet legal requirements imposed by a political entity concerning the improvement or marketing of specific products or processes are allocated only to income from sources within that jurisdiction if the requirements are not expected to generate significant gross income outside the jurisdiction.[88] The balance is apportioned under the rules (gross income or gross sales methods) described above.[89]

Under tortuous effective date rules, the post-1987 rules are effective only for the first four months of the first post-1987 year. Section 1.861-8(e)(3) of the Treasury Regulations applies to the balance of that year and to the following year. In general, those regulations provide for allocation and apportionment of the expenses under the sales or optional gross income methods.[90] Rules identical to the post-1987 rules were codified in section 864(f) in 1989, effective only for nine months of the taxable year beginning in the period from August 2, 1989 to August 1, 1990. The Omnibus Budget Reconciliation Act of 1990 provides that section 864(f) is effective for the balance of the post-August 1, 1989 taxable year and for the taxable year beginning in the subsequent one year period ending on or before August 1, 1991.[91] It appears unlikely that the post-1987 rules will become permanent before the Treasury issues the study on the impact of research

87. The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4009(a), 102 Stat. 3342 (1988). For a detailed discussion of the gross income and gross sales methods, see B. BITTKER & L. LOKKEN, *supra* note 70, at 70-50 to 70-54.

88. The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4009(a)(1), 102 Stat. 3342 (1988).

89. The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4009(a)(2), 102 Stat. 3342 (1988).

90. Under the sales method, 30% of the expenses are allocated and apportioned on the basis of the location of the tax payers activities that account for more than 50% of the research and development deduction. The balance is apportioned on the basis of sales. Treas. Reg. § 1.861-8(e)(3)(ii) (1990).

91. The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11401(a), 104 Stat. 1388 (1990), indicates that the provisions of section 864(f) are effective for the first two taxable years beginning after August 1, 1989 and on or before August 1, 1991.

and development expenditure allocations directed by Congress in the 1986 Tax Reform Act. The post-1987 rules do not apply for purposes of allocation and apportionment of R & D expenses of foreign taxpayers.

3. Certain Transfers to Foreign Related Parties

If intangible property is transferred by a United States person[92] to a foreign corporation in a transaction described under sections 351 (transfers of property in exchange for at least eighty percent of the stock) or 361 (corporate reorganizations) of the Code, the transfer is deemed to be for payments contingent upon the productivity, use or disposition of the intangible.[93] In addition, the United States person is treated as receiving amounts, commensurate with the income attributable to the intangible,[94] which would have been received over the useful life of the property;[95] and those amounts are treated as United States source ordinary income.[96] The purpose of the section 367(d) provisions is two-fold. First, it subjects outbound transfers of intangibles, in a form other than a sale or license, to related foreign corporations to the same arm's length scrutiny required under section 482.[97] Second, the characterization of income as United States source ensures that any foreign taxes paid or deemed to be paid on income derived from the intangible will not be eligible for the foreign tax credit allowed against the

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92. I.R.C. § 7701(a)(30) (1990).

93. I.R.C. § 367(d)(2)(A)(i) (1990). If section 367(d) were not applicable, the rules under sections 351 and 361 generally would provide for nonrecognition of gain on the transfer of appreciated intangibles if certain requirements are met. I.R.C. §§ 351, 361 (1990).

94. The commensurate with income standard here is identical to that employed in section 482. *Compare* I.R.C. § 367(d)(2)(A)(i) *with* I.R.C. § 482 (1990).

95. If the foreign corporation disposes of the intangible, amounts treated as being received are determined at the time of the disposition. I.R.C. § 367(d)(2)(A)(ii)(II) (1990).

96. I.R.C. § 367(d)(2)(A), (C) (1990).

97. The typical situation sought to be outlawed was one in which a United States company conducted research and development in the United States, deducting such expenses against United States income, and transferred the resulting intangible property outside of the United States to a foreign corporation, organized in a low tax jurisdiction. Because the foreign corporation was not subject to United States income tax jurisdiction, the United States company could escape or defer United States tax on the appreciation. STAFF OF JOINT COMM. ON TAX'N, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 at 427 (Comm. Print 1984) [hereinafter 1984 Bluebook]. If an adjustment is made under section 482, the special source recharacterization rules of section 367(d) do not apply. *Id.* at 433.

United States tax liability of the United States transferor.[98] The above rules do not apply to transfers made in connection with a *bona fide* cost sharing arrangement.[99]

C. *Advance Determination Rulings*

In the spring of 1990, a discussion draft of a proposed revenue procedure (procedure or draft procedure) was circulated by the IRS to tax practitioners and bar associations concerned with issues relating to transfers of property between related taxpayers.[100] The procedure provides guidelines for obtaining an advance determination ruling (ADR) concerning the possible application of section 482 to various international transactions.[101] While the procedure purports to encompass ADRS regarding the application of section 482 to any transactions between commonly controlled parties, the drafters expect that it will be invoked largely in matters involving transfer pricing issues or cost sharing arrangements between affiliated corporations.[102] The availability of an advance determination procedure has been proposed in order to reduce the amount of time normally spent in the lengthy process of resolving transfer pricing issues. In addition, the IRS hopes that the process will provide some amount of certainty and predictability for taxpayers regarding the tax

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98. For a discussion of the foreign tax credit limitation of section 904(a) of the Code, see *supra* note 72.

99. The special rules of section 367(d) do not apply to transfers in connection with *bona fide* cost sharing arrangements. 1984 Bluebook, *supra* note 97, at 433.

100. McIntyre, *IRS Draft Procedure on Advance Approval of Pricing and Cost-Sharing Methods Circulated,* 2 TAX NOTES INT'L 545 (June 1990). The draft procedure is an unofficial document that was circulated by the Service in order to obtain comments. *Id.* The Service intended that the contents of the document remain confidential. *Id.* Confidentiality was destroyed when the document was circulated and eventually published in Tax Notes International. *Id.* The Service finalized the advance ruling procedures in Rev. Proc. 91-22, 1991-11 I.R.B. 11 (March 18, 1991). The binding understanding reached under the procedure is termed an "advance pricing agreement." Because this Article was going to press when Rev. Proc. 91-22 was issued, time did not permit inclusion of references to distinctions between the proposal and the final procedure. A companion to the final rules, Rev. Proc. 91-23, 1991-11 I.R.B. 18 (March 18, 1991), provides procedures for requesting United States competent authority assistance when taxation is alleged to violate a United States tax treaty.

101. The cost of submitting a request for an advance determination is $5,000. Rev. Proc. 90-___, *Full Text of Draft Revenue Procedure on Advance Transfer Pricing Rulings,* 2 TAX NOTES INT'L 565, 572, § 5.15 (June 1990) [hereinafter *Text of Procedure*]. One commentator notes that the procedure, when issued, may refer to an advance determination ruling (ADR) as an "advance pricing agreement." McIntyre, *Editor's Notebook,* 3 TAX NOTES INT'L 27, 29 (Jan. 1991).

102. *Text of Procedure, supra* note 101, at 565, § 2.01.

consequences of planned international transactions.[103] Discussion of the proposal follows.

The goal of the procedure is to "produce an understanding between the Service and the taxpayer on an appropriate method under section 482 for determining the transfer pricing practices or cost sharing arrangements of controlled taxpayers."[104] The ability of a taxpayer to ensure that an understanding is reached, however, is limited by the right of the Service unilaterally to refuse to consider any issue in an advance ruling request and to refuse to issue a ruling on any issue.[105] While the Service has not restricted its ability to determine ultimately the areas in which there may be no agreement, it has suggested that advance notice of the areas in which no ruling will be given may be provided in the future.[106]

The draft procedure is designed to permit a taxpayer to request a ruling that a proposed method for treating intercompany transactions clearly reflects the income of the taxpayer and related parties. The proposed method must derive from the section 482 regulations[107] and the request must comply with prescribed requirements.[108] The effect of a ruling is that the section 482 method chosen by the taxpayer "will be deemed to clearly reflect the income of" commonly controlled parties.[109]

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103. *Text of Procedure, supra* note 101, at 565-66, § 3.01.

104. *Text of Procedure, supra* note 101, at 566, § 3.02.

105. *Text of Procedure, supra* note 101, at 565, § 2.02. The right to decline to consider a request should be modified to permit a taxpayer to protest a refusal to rule. The procedure provides little clue as to the possible grounds for a refusal. The Service suggests, however, that the "highly technical factual nature" of certain multinational intercompany transactions may render inappropriate the advance ruling process. *Id.* at 565-66, § 3.01. While it is appropriate to recognize that a transaction may be too technically complex for the process, it is not appropriate for the Service to assert a unilateral right to decline to consider a request on the ground of technical complexity without enunciation of standards to be applied. Consequently, the Service should propose more detailed guidelines in the "no ruling" area.

106. *Text of Procedure, supra* note 101, at 565, § 2.02.

107. For a discussion of the section 482 regulations, see *supra* notes 8-15. Those regulations will be amended to reflect proposals discussed in The White Paper, *supra* note 14. An economic approach not specifically mentioned in the regulations may also be acceptable. *Text of Procedure, supra* note 101, at 566, § 4.03.

108. The requirements are described in *Text of Procedure, supra* note 101, at 566-68, § 4.

109. *Text of Procedure, supra* note 101, at 566, § 4.02. The procedure employs the term "apportionment method." *Id.* The term connotes any "method of distribution, apportionment, or allocation of gross income, deductions, credits, or allowances between or among the organizations, trades, or businesses specified in the ruling." *Id.* Unless the Service and the taxpayer agree otherwise, the fact that the taxpayer did or did not re-

A method endorsed under the advance procedure will be "the most reasonable one."[110] It must clearly reflect income, be supported by the best available and reliable data, require few adjustments, and be administrable.[111] If possible, supporting data submitted by the taxpayer must identify comparable independent competitors.[112] If no comparable competitors exist, the taxpayer must identify similar businesses.[113] A taxpayer that is unable to find comparable competitors or similar businesses must demonstrate that its transfer pricing method satisfies the requirements that the method be reasonable and clearly reflect income.[114]

Provided that a taxpayer can establish that "critical assumptions, data, and computations" relied upon by the Service in issuing the ADR continue to be valid and consistently applied, transfer prices involving transactions that occur during the period covered by an ADR will not be challenged by the Service.[115] Deviation of the factors involved in taxpayer's actual operations from the data relied upon in the ADR will be permitted if it falls within specified limits.[116] In order to rectify insubstantial anticipated deviations — those that fall within specified limits — a taxpayer must make appropriate pricing adjustments.[117]

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quest an advance ruling or that the taxpayer proposed a particular apportionment method may not be relied upon by the taxpayer or the government in a later administrative or judicial proceeding. *Id.* The apparent intent of the above requirement is that only the Service's final determination be binding.

110. *Text of Procedure, supra* note 101, at 566, § 4.03. The Service will accept economic approaches not specified in the section 482 regulations if they clearly reflect income. *Id.* As an example of an approach not expressed in the regulations, the procedure offers the example of a formulary approach that applies only to the specific facts and circumstances of a taxpayer. *Id.*

111. *Text of Procedure, supra* note 101, at 566, § 4.03. There are detailed rules concerning the nature of the documentation that must support a request. *See id.* at 569-72, § 5. The Service possesses the right to request any information related to the taxpayer's operations "deemed necessary in order to arrive at a mutually agreeable basis for a ruling." *Id.* at 567, § 4.06. The Service may request the provision of an independent expert at the taxpayer's expense. *Id.*

112. *Text of Procedure, supra* note 101, at 566, § 4.04.

113. Under rules provided in section 5 of the procedure, the taxpayer must document efforts undertaken to obtain information regarding comparable or similar businesses. *See, e.g., Text of Procedure, supra* note 101, at 569-71; § 5.07; § 5.08.

114. *Text of Procedure, supra* note 101, at 566, § 4.04(a). Those requirements are set forth in section 4.03. *Id.* at 566, § 4.03.

115. *Text of Procedure, supra* note 101, at 566, § 4.04(b), (c).

116. *Text of Procedure, supra* note 101, at 566, § 4.04(d). Permitted deviation may involve percentage variations or differences in monetary amount. *Id.*

117. *Text of Procedure, supra* note 101, at 566, § 4.04(d). Guidelines for making the adjustments are contained in Rev. Proc. 65-17, 1965-1 C.B. 833. *Id.* Considering the

The adjustments may apply the premises of the original ADR to the revised data.[118] Where the factors deviate substantially, that is, they fall outside of specified limits the Service has the right to propose pricing adjustments to transactions covered by the ADR.[119]

It is expected that an initial ADR will be effective for a period, no longer than three years, beginning after the date of the ruling.[120] An ADR may be revoked for cause or it may be revised or cancelled because of an unavoidable change in critical assumptions supporting the initial grant of a ruling.[121]

A revocation for cause may occur when the taxpayer does not comply with terms and conditions of the ruling or when the taxpayer misrepresents or omits a material fact.[122] Because a revocation for cause normally relates back to the effective date of the ADR, additional taxes, interest, and penalties will be assessed as though the ruling had never been issued.[123] Relief from the retroactive effect of a revocation for cause may be obtained under section 7805(b) of the Code[124] only if the taxpayer estab-

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guidelines set forth in the White Paper, it is presumed that permitted adjustments will be minor. The procedure, however, is silent on this issue.

118. *Text of Procedure, supra* note 101, at 566, § 4.04(c). All recipients of an ADR are required to explain and document, in an annual report described in section 4.09, compliance with the rules regarding deviations. The annual report must be filed within 120 days after the close of the taxable year. *Id.* at 568, § 4.09(b). In addition to information regarding the taxpayer's operations, the report also must contain information concerning possible grounds for renewal, revocation, revision, or cancellation of the ruling (sections 4.05(c)-(f)) and requirements relating to the contents of the ruling request (sections 5.01, 5.02(d), 5.03(c)-(e), 5.05, 5.06-5.08, 5.12-5.13). *Id.* at 568, § 4.09(d).

119. The right is implied by section 4.04(c). Where there is a substantial deviation in operating results, there is deemed a change in critical assumptions supporting the initial ruling. *Text of Procedure, supra* note 101, at 567, § 4.05(f). On this ground, the ruling will be subject to revision or cancellation under rules specified in section 4.05(e). *See infra* notes 121-32.

120. *Text of Procedure, supra* note 101, at 566-67, § 4.05(a), (b). Actual duration of the ruling depends upon the facts and circumstances involved. Requests for renewal, accompanied by new supporting documentation, may be filed before the end of the initial term of the ruling. *Id.* at 567, § 4.05(c).

121. *Text of Procedure, supra* note 101, at 567, § 4.05(d), (e).

122. The noncompliance, misrepresentation, or omission may relate to the ruling, subsequent filings or the annual report. *Text of Procedure, supra* note 101, at 567, § 4.05(d).

123. *Text of Procedure, supra* note 101, at 567, § 4.05(d). Additional serious consequences result from a revocation for cause. For example, a revocation may result in denial of relief under Rev. Proc. 65-17, 1965-1 C.B. 833 (in certain circumstances permitting taxpayers to conform accounts to reflect section 482 adjustments without further federal income tax consequences). *Id.*

124. I.R.C. § 7805(b) (1990).

lishes that it substantially complied with the terms and conditions of the ADR and that it disclosed and properly stated all material facts.[125]

An ADR may be revised or cancelled on the ground that there was a change in critical assumptions made on issuance that renders the ruling unfair or unworkable.[126] Where there is a change in critical assumptions, there is no automatic revocation of the ADR as in the case of a revocation for cause.[127] Instead, it is contemplated that the taxpayer and the Service will negotiate revision or cancellation of the ruling.[128] There is a presumption that the initial ruling will remain in effect unless an agreement to revise the ruling is reached by the Service, the taxpayer and, if applicable, the appropriate competent authority. If there is no successful negotiation of a revised ruling, the cancellation of the initial ruling will be effective no earlier than the beginning of the tax year in which the change in assumption occurs.[129] The date on which the change occurs marks the latest possible cancellation date.[130] A change in assumption within the control of the taxpayer or a change not initiated for compelling business purposes will constitute a ground to revoke the ruling for cause.[131] In such a case, automatic revocation by the Service would occur unless the taxpayer qualified for relief specified above in the discussion concerning revocations for cause.[132]

While the grant of an ADR is not conditioned upon reaching agreement with competent authorities of affected foreign countries, the procedure contemplates that the ruling may include such an agreement where the taxpayer conducts activities

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125. *Text of Procedure, supra* note 101, at 567, § 4.05(d).

126. *Text of Procedure, supra* note 101, at 567, § 4.05(e). The procedure offers as examples of a change in critical assumptions "a significant change in business operations or a substantial uncontrolled economic event." *Id.* A change in a critical assumption is deemed to have occurred when the factors involved in a taxpayer's actual operations are outside of the specified limits in the ADR. *Id.* at 567, § 4.05(f).

127. *Text of Procedure, supra* note 101, at 567, § 4.05(e). For a discussion of the periodic review of transfer pricing arrangements, see The White Paper, *supra* note 14, at 478-79. While minor variations in income do not trigger review, substantial changes do. *Id.* at 478.

128. *Text of Procedure, supra* note 101, at 567, § 4.05(e). The taxpayer must notify the Service of a change in a critical assumption during the year of the change, but no later than the date for filing the annual report required by section 4.09 of the procedure. *Id.*

129. *Text of Procedure, supra* note 101, at 567, § 4.05(e).

130. *Text of Procedure, supra* note 101, at 567, § 4.05(e).

131. *Text of Procedure, supra* note 101, at 567, § 4.05(e).

132. *See supra* notes 122-25 and accompanying text.

in a foreign country.[133] The procedure anticipates that an agreement with an affected foreign authority will be reached in every case in which the taxpayer's operations involve a treaty partner.[134] It adopts the requirements for disclosure of taxpayer information that normally apply in matters in which the Service and a foreign country attempt to resolve cases of double taxation.[135]

A ruling will be issued without a competent authority agreement when taxpayer operations involve a foreign country that does not have a tax treaty with the United States or when the taxpayer requests a unilateral understanding with the United States.[136] The Service will enter into a unilateral understanding only when the taxpayer shows "good and sufficient reasons."[137] A unilateral ruling issued by the Service will nonetheless be governed by the competent authority rules detailed in Revenue Procedure 82-29 when taxpayer's use of the approved method leads to double taxation by the United States and a treaty partner. In addition, any affected foreign country that has an agreement with the United States concerning the ADR procedures will be notified of a unilateral ruling.[138]

In order to determine whether the factors upon which the ADR was based remain valid, the Service reserves the right to audit the operations of the taxpayer.[139] Where possible, the Service will coordinate the examination with a foreign country that has an agreement with the United States concerning the taxpayer's pricing method.[140] The purpose of the examination is to verify the accuracy of the taxpayer's representations, not to reevaluate the pricing method approved in the ADR.[141] The ex-

133. *Text of Procedure, supra* note 101, at 567-68, § 4.07(a), (c).

134. *Text of Procedure, supra* note 101, at 567-68, § 4.07(c). For a brief view of British, French, and German reaction to the ADR procedure, see *Override Articles May Appear in Future U.S. Treaties, Morrison Warns; Foreign Officials Discuss ADR*, 49 TAX NOTES 609, 611-12 (Nov. 5, 1990).

135. *Text of Procedure, supra* note 101, at 567, § 4.07(b). The guidelines announced in Rev. Proc. 82-29, 1982-1 C.B. 481, apply. *Id.* An attempt will be made to protect trade secrets of the taxpayer.

136. *Text of Procedure, supra* note 101, at 567-68, § 4.07(c).

137. *Text of Procedure, supra* note 101, at 567-68, § 4.07(c).

138. *Text of Procedure, supra* note 101, at 567-68, § 4.07(c). Presumably, once the draft procedure is finalized, the Service will begin to negotiate mutual agreements with treaty partners concerning the ADR process.

139. *Text of Procedure, supra* note 101, at 568, § 4.10.

140. *Text of Procedure, supra* note 101, at 568, § 4.10(f). *See also id.* at 567-68, § 4.07(c).

141. *Text of Procedure, supra* note 101, at 568, § 4.10(b). The examination will also

amination may result in modification of the ADR, however, if the examiner recommends revision, revocation, or cancellation.[142] Documentation supporting the ADR request must be retained for an unlimited period — "as long as they are relevant" — unless the ADR specifies a shorter one.[143] Local and foreign-based supporting documentation must be produced on demand.[144]

An ADR request must provide detailed information designed to assist the Service in its determination of the appropriate pricing method.[145] A significant requirement is that the

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determine whether the taxpayer has complied with the terms and conditions of the ADR and whether transactions were carried out as predicted. *Id.*

142. The examiner may use a pricing method other than the one approved in the ruling if she determines that the ADR must be modified. *Text of Procedure, supra* note 101, at 568, § 4.10(d).

143. *Text of Procedure, supra* note 101, at 568, § 4.10(c).

144. *Text of Procedure, supra* note 101, at 568, § 4.10(c). Local records must be produced within 60 days and foreign-based documents must be produced within 120 days of the request. A foreign country's imposition of a penalty for disclosure of the requested material is not a sufficient ground for failure to comply. These rules should be considered in connection with other information reporting and record-keeping requirements. *Id. See infra* notes 177-225 and accompanying text.

145. These rules are set forth in section 5 of the procedure. Specifics regarding the contents of the request will be discussed in detail only if noteworthy. The request must establish that the pricing method proposed by the taxpayer complies with the "clear reflection" of income requirement in section 482 and the "arm's-length standard" set forth in United States income tax treaties. *Text of Procedure, supra* note 101, at 570, § 5.07. The procedure does not state whether the "clear reflection of income" and "arm's-length" standards are equivalent and it does not suggest a method for resolving any difficulty created by conflicting requirements of the two standards.

Extensive documentation requirements in the procedure are consistent with the Treasury's indication in The White Paper, *supra* note 14, at 461, that a significant problem in intangibles pricing cases is "access to relevant information." In support of the suitability of the pricing method chosen, the taxpayer must submit the following information: all pertinent measures of profitability and return on investment, a functional analysis of each party involved, economic analysis of the general industry pricing practices, all pertinent measures of profitability within the industry, a list of competitors and a discussion of similarities or comparability, a detailed presentation of comparability criteria used to identify competitors, and profitability measurements for independent comparable competitors. *Text of Procedure, supra* note 101, at 570, § 5.07(a)-(h).

If a cost sharing arrangement is involved, the taxpayer must submit the following information: the date the arrangement commenced and the date of a writing reflecting the arrangement, the date each party entered into the arrangement, the history of the business operations and principal business activities of each participant, each participant's contribution, whether royalties were paid as a result of contribution of intangibles, the extent of research and development efforts, the basis for measurement of each participant's benefit, the extent to which developmental costs are to be shared, the ownership right of each participant, any changes in the arrangement, procedures for periodically estimating benefits, accounting procedures, treatment of cost sharing payments for United States tax purposes, gross and net profitability in the product area for each partaxpayer provide information concerning business operations of members of the commonly controlled group that are not parties to the request.[146] The requirement may be viewed as a pretext for an unwarranted foray into confidential business records of controlled group members who are not involved in the transactions covered by the ruling request.[147] Moreover, the requirement may be disfavored because compliance could require provision of information not within the taxpayer's control.[148]

A taxpayer is entitled to a conference in the National Office of the IRS during the Service's consideration of the ADR. The right to a conference also exists when the Service indicates an intention to deny the request.[149] Where the taxpayer's activities are conducted in a foreign country that has a tax treaty with the United States, the Service will notify the competent United States authority, who has responsibility for supervision of matters affecting tax treaty provisions, of the submission of the request.[150] The Service's consideration of an ADR may involve negotiations with affected foreign governments.[151] The Service may condition the issuance of a ruling upon mutual agreement with foreign competent authorities.[152] The procedure strongly sug-

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ticipant, provisions for the buy-in of a new participant, expansion of existing rights or withdrawals from the arrangement, payments for contract research, payments from third parties for intangible property developed through the arrangement, similar or comparable arrangements between related and unrelated parties, and existence of documents concerning operation of the arrangement. *Id.* at 570-71, § 5.08(a)-(s).

Another requirement is that the taxpayer submit the names of two independent experts for each country affected by the pricing method proposed by the taxpayer. *Id.* at 569, § 5.02(d). Requirements relating to independent experts are described in section 6.08 of the procedure. The White Paper urged that the early use of counsel and experts would save the taxpayer and the government "substantial sums of time and money." The White Paper, *supra* note 14, at 464.

146. *Text of Procedure, supra* note 101, at 569, § 5.02(b). By contrast, information concerning pricing methodologies is required only of members of the controlled groups that are parties to the request. *Id.* at 569, § 5.04.

147. *See* Matthews & Turro, *International Conferences Focus on Transfer Pricing, Financing*, 49 TAX NOTES 267 (Oct. 15, 1990).

148. Considering the existence of parallel record-keeping requirements in sections 6038A, 6038C of the Code which are generally applicable to section 482-related parties, it is not likely that the ADR documentation requirements will be altered. For an examination of the potential benefits of an ADR, see Epstein, *Potential Opportunities and Costs in Filing for an Advance Determination Ruling on International Transfer Prices*, 19 TAX MGMT. INT'L 480 (Nov. 1990).

149. *Text of Procedure, supra* note 101, at 572, § 6.03(a), (b). An ADR request may be withdrawn at any time before the issuance of the ruling. *Id.* at 572, § 6.03(c).

150. *Text of Procedure, supra* note 101, at 572, § 6.04.

151. *Text of Procedure, supra* note 101, at 572, §§ 6.04, 6.06.

152. *Text of Procedure, supra* note 101, at 572, § 6.06. As indicated in section

gests that the taxpayer initiate available parallel proceedings for the issuance of a similar ruling with affected foreign competent authorities.[153]

A particularly sensitive matter concerns possible limitations on disclosure of information obtained by the Service and treaty partners under the procedure. Rules related to disclosure matters are still under consideration.[154]

The Treasury expects that the ADR procedures will be finalized before the end of 1991. A Treasury official recently noted the final procedure will probably make optional the use of two independent experts in each affected country and will reflect flexibility regarding the effective period of an ADR.[155]

D. International Cooperation and the Proposed EC Arbitration Convention

In a move to advance international cooperation in transfer pricing matters, the Council of European Community Finance Ministers (Council) in June 1990 adopted the proposed Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (Convention).[156] As in the case of other measures adopted at the same time (the parent-subsidiary and merger directives), the Council hopes that the Convention will be ratified no later than December 31, 1991.[157] The Convention culminates efforts on the part of the

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4.07(c) of the procedure, there are some circumstances in which agreement with a competent authority of a foreign country will not be required. Presumably, when an agreement is not required under section 4.07(c), issuance of a ruling by the Service will not be conditioned upon such an agreement. The procedure is silent on this point.

153. *Text of Procedure, supra* note 101, at 572-73, § 6.07. The procedure does not require that the taxpayer file a request with a foreign competent authority. However, the Service expects that such a filing will occur. *Id.*

154. *Text of Procedure, supra* note 101, at 568, § 4.08.

155. *See* Rosen, *Triplett Offers Insights Into Final ADR Procedure,* 49 TAX NOTES 838 (Nov. 19, 1990) [hereinafter Rosen]. The independent expert requirement is contained in section 5.02(d) of the procedure. For a discussion of the rules relating to the effective period of a ruling, see *supra* note 120 and accompanying text. Selected recent transfer pricing matters already have been handled in accordance with the guidelines set forth in the proposed procedure. *See* Rosen, *supra.*

156. *See* Killius, *The EC Arbitration Convention,* 10 INTERTAX 437 (Oct. 1990) [hereinafter Killius]. For the complete text of the Convention, see *The Arbitration Convention,* 10 INTERTAX 510 (Oct. 1990) [hereinafter *Text of Convention*].

157. *See* Killius, *supra* note 156, at 440. The Convention will become effective on the first day of the third month following the month in which the last signatory deposits its instrument of ratification with the Secretary-General of the Council of the European Community. *See Text of Convention, supra* note 156, at 516, art. 18.

European Community (EC) that began in 1976.[158] It is viewed as complementary to rules specified in the EC Directive on Mutual Assistance in Tax Matters, adopted in 1977 and amended in 1979,[159] and the mutual agreement procedures set forth in article 25 of the 1977 Organization For Economic Co-operation and Development Model Convention on Double Taxation.[160] The Convention is to be effective only for a five year period unless the contracting states agree to extend it.[161]

The Convention will provide special assistance in matters in which multinational enterprises are subject to double taxation as a result of inconsistent positions taken by Convention signatories in transfer pricing cases. The mutual agreement and arbitration procedures become operative in situations in which enterprises in at least two contracting states are under common control. In effect, the Convention permits contracting parties to make adjustments in transactions between commonly controlled entities on the basis of the "arm's length standard." If the enterprises are managed so that their "commercial or financial relations" differ from those which would obtain between independent enterprises, then profits that would have inured to one enterprise absent the control may be taxed.[162] The procedures also apply where a branch, or permanent establishment, of a contracting state is involved.[163]

If the enterprise believes that a contracting state has not made transfer pricing or other adjustments in accordance with the standard of an independent enterprise, it may present its case to the competent authority of the contracting state in which it is resident (or in which its branch is located).[164] If the compe-

158. Killius, *supra* note 156, at 439-40.

159. Killius, *supra* note 156, at 440.

160. Killius, *supra* note 156, at 440.

161. *Text of Convention, supra* note 156, at 517, art. 20.

162. *Text of Convention, supra* note 156, at 513, art. 4.

163. *Text of Convention, supra* note 156, at 513, art. 4. Joint Declarations to the Convention provide that these rules would also apply to a branch of an enterprise in a contracting state that is located in a third country. *Id.* at 517, Declaration on art. 4(1). Except as provided above in the Joint Declarations, a permanent establishment is deemed to be a resident of the state in which located. *Id.* at 511, art. 1(2). The Convention applies whenever the profits of an enterprise of one contracting state are included in the profits of an enterprise of another contracting state. *Id.* at 511, art. 1(1). This rule has not been interpreted to preclude the application of the Convention to an enterprise of a contracting state (a Dutch corporation) and a permanent establishment of another enterprise of the same contracting state located in a second contracting state (the French branch of another Dutch corporation). *See* Killius, *supra* note 156, at 441-42.

164. *Text of Convention, supra* note 156, at 513, art. 6.

tent authority is unable to resolve the matter independently, it may seek to resolve double taxation problems by agreement with any other contracting state involved. If no agreement is reached under the mutual agreement procedures, the contracting state must refer the matter to an advisory commission within two years from the date the matter was first submitted to the competent authority.[165]

A contracting state is not required to invoke the mutual agreement or advisory commission procedures if there has been a final ruling that actions of the enterprise giving rise to the requested adjustment have resulted in a "serious penalty."[166] Each of the contracting states has provided a declaration regarding its understanding of the term "serious penalty."[167] The United Kingdom, for example, interprets the term "serious penalty" to mean criminal and administrative sanctions relating to the fraudulent or negligent delivery of incorrect accounts, claims or returns for tax purposes.[168] An advisory commission need not be established if compliance with an advisory opinion would require a contracting state to contravene its domestic law by deviating from a final judicial decision.[169]

The advisory commission is required to issue an opinion eliminating double taxation within six months after the matter is referred to it.[170] In the course of its deliberations, the commission may request documents and testimony of the multinational enterprise and the competent authorities of the contracting parties.[171] The advisory committee is to consist of a chairman, two

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165. *Text of Convention*, *supra* note 156, at 514, art. 7.

166. *Text of Convention*, *supra* note 156, at 514, art. 8.

167. *Text of Convention*, *supra* note 156, at 518 (listing Unilateral Declarations of Member States).

168. *Text of Convention*, *supra* note 156, at 519.

169. *Text of Convention*, *supra* note 156, at 514, art. 7.

170. *Text of Convention*, *supra* note 156, at 516, art. 12. Under article 14, double taxation is eliminated if profits are included in the computation of taxable profits of one state only or there is a credit allowed against the tax on profits in one state for the tax imposed on the same profits in another state. *Id.*

171. *Text of Convention*, *supra* note 156, at 515, art. 10. The multinational enterprise is entitled to present any information deemed likely to be relevant to the deliberations and is entitled to appear and be represented before the commission. The contracting states are excused from presenting information to the commission in the following circumstances: (1) to supply the information would be at variance with domestic law or normal administrative practice, (2) the state would be required to supply information not obtainable under domestic law or normal administrative practice, or (3) the state would disclose trade, business, or industrial secrets or information required to remain secret for reasons of public policy. *Id.*

representatives of each competent authority, and an even number of other persons appointed from a formal list of nominees by agreement of the competent authorities or by drawing lots.[172] All commission members are obligated to keep secret all information presented at the proceedings.[173] An opinion is adopted by a simple majority of the members.[174] The authorities must act in accordance with the opinion unless they agree to take different action.

The United States is a proponent of the view that international cooperation among taxing authorities in transfer pricing matters should be encouraged. Because it is not a member of the EC, it is, however, unable to become a signatory to the Convention.[175] Nonetheless, the Convention should serve as a model for future multilateral cooperation efforts by the United States because the provision for mandatory arbitration of disputes holds the strongest guarantee that multinational businesses will not be subject to conflicting approaches by taxing authorities.[176]

III. Information Reporting and Transfers of Intangible Property

The success of United States transfer pricing methodology is largely dependent upon the availability of suitable enforcement mechanisms. One of those mechanisms is the requirement of information reporting. The requirement is intended to assure accuracy in implementation of pricing methodology. It may also have the unfortunate effect of making compliance so burdensome that taxpayers may grow reluctant to adhere to the rules. Selected information reporting provisions are discussed below.

A. *United States-Owned Foreign Businesses (section 6038)*

Annually, each "United States person" must file with the

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172. *Text of Convention, supra* note 156, at 514-15, art. 9.

173. *Text of Convention, supra* note 156, at 514-15, art. 9.

174. *Text of Convention, supra* note 156, at 515, art. 11.

175. *See* Letter from Treasury Secretary Nicholas F. Brady to United Kingdom Chancellor of the Exchequer John Major (Aug. 29, 1990), *reprinted in* 48 Tax Notes 1436 (Sept. 10, 1990).

176. The United States has already indicated a commitment to bilateral cooperation in transfer pricing matters in the provisions of the proposed ADR procedures. *See supra* notes 133-38 and accompanying text. Moreover, the recently ratified United States-Germany treaty contains an elective provision for arbitration of disputes. *See* Killius, *supra* note 156, at 438-39.

Service an information return relating to each foreign corporation which it controls (owns more than fifty percent of the value of all classes of stock or more than fifty percent of the voting stock).[177] For post-1989 periods, if the Treasury enacts implementing regulations, even a United States shareholder who alone does not control a foreign corporation may be required to file an information return if the foreign corporation is controlled (more than fifty percent as above) by United States persons[178] and the shareholder holds at least ten percent of the voting stock. The return must furnish information concerning the nature of the foreign corporation's business, the location of the foreign corporation's books and records, the identity of all United States persons that own at least five percent of the value of the stock, the contents of the foreign corporation's financial statements, and a description of most transactions (sales and purchases of inventory, tangible and intangible property, payments, loans, dividends paid) with the foreign corporation or between the foreign corporation and any other corporation controlled by the United States person, including more than fifty percent owned subsidiaries[179] of the foreign corporation.[180]

There is a $1,000 penalty for each annual failure to file the required information.[181] There is a separate penalty equal to a ten percent reduction in the amount of taxes paid to a foreign country or deemed paid under special Code provisions (sections

177. I.R.C. § 6038 (1990). The term "United States person" includes, with minor exceptions, a United States resident or citizen, a domestic corporation, and a domestic partnership. I.R.C. § 7701(a)(30) (1990); Treas. Reg. § 1.6038-2(d) (1990). The reporting requirement only applies if control exists for at least 30 consecutive days during the United States person's accounting period. Treas. Reg. § 1.6038-2(a), (b) (1990). For years after 1983, the return is filed on Form 5471. Treas. Reg. § 1.6038-2(a) (1990).

178. In order to constitute part of the control group, a United States person must be a United States shareholder — that is, must own at least 10% of the voting stock directly or through attribution rules. I.R.C. §§ 6038(a)(4); 957(a), (c); 951(b) (1990).

179. Treas. Reg. § 1.6038-2(b) (1990).

180. Treas. Reg. § 1.6038-2(f), (g) (1990). Transactions between the foreign corporation and any United States person owning at least 10% of the value of the stock or any corporation controlling the foreign corporation also must be reported by the United States person. *Id.* Presumably, after regulations are issued for post-1989 years, 10% United States shareholders will be subject to an independent reporting requirement. A 1989 amendment to the Code requires that a United States person report any other information similar to that listed which the Treasury Secretary determines to be appropriate to carry out the provisions. I.R.C. § 6038(a)(1) (1990).

181. I.R.C. § 6038(b)(1) (1990). The penalty escalates to $1,000 (with a maximum under the escalation clause of $24,000) for each 30 day period during which the United States person fails to comply with the reporting requirement after notification from the Service. I.R.C. § 6038(b)(2) (1990).

902, 960 allowing corporate United States shareholders of controlled foreign corporations credit for taxes paid by the corporations) for foreign tax credit purposes.[182] The penalties are not cumulative, as the foreign tax credit reduction is reduced by the amount of the dollar penalty.[183]

B. *Foreign-Owned Domestic Businesses (section 6038A)*

Foreign owned corporations are also subject to information reporting requirements.[184] Any domestic corporation which is at least twenty-five percent-foreign owned (twenty-five percent of the voting power or twenty-five percent of the total value of all classes of stock is owned by any one person that is not a United States person)[185] must, under section 6038A, report prescribed information (a corporation required to report is termed a reporting corporation).[186] Information that must be reported includes: (1) the identity and nature of business of each twenty-five percent-foreign shareholder and each person related within the meaning of section 482 (related parties)[187] that entered into any transaction with the reporting corporation; (2) the manner in which the reporting corporation and the foreign person are related; and (3) transactions with each related party.[188] Each reporting corporation is also required to maintain records (specified in regulations)[189] sufficient to enable the Service to

182. I.R.C. § 6038(c) (1990). The amount of the reduction is limited to the greater of $10,000 or the foreign corporation's income for the reporting period. *Id.*

183. I.R.C. § 6038(c)(3) (1990). Reasonable cause for failure to furnish information or to act after notice of such failure may eliminate the penalty. Treas. Reg. § 1.6038-2(k)(3) (1990).

184. I.R.C. § 6038A (1990). Before enactment of the Omnibus Budget Reconciliation Act of 1990 on November 5, 1990, the provisions of section 6038A also governed foreign corporations engaged in a trade or business in the United States. I.R.C. § 6038A (1988). The rules relating to foreign corporations are now contained in new section 6038C. *See infra* notes 214-19 and accompanying text.

185. I.R.C. § 6038A(c)(1) (1990). In determining ownership and relationship, modified section 318 rules apply. I.R.C. § 6038A(c)(5) (1990). Before July 10, 1989, the reporting requirements applied only to corporations owned 50% or more by one foreign person. I.R.C. § 6038A(c)(1) (1989).

186. I.R.C. § 6038A(a) (1990). The information must be reported on Form 5472. Treas. Reg. § 1.6038A-1 (1990).

187. Also covered are transactions with any person related within the meaning of section 267(b) or section 707(b)(1) to the reporting corporation or to a 25% shareholder of the reporting corporation. I.R.C. § 6038A(c)(2) (1990).

188. I.R.C. § 6038A(b) (1990).

189. It was recently acknowledged by the Service that this requirement may force some firms to "manufacture" documents. *See* Turro, *No Records is No Excuse Under Upcoming 6038A Regs, IRS Warns*, 49 TAX NOTES 947 (Nov. 26, 1990) [hereinafter

determine the correct treatment of transactions with related parties.[190] Proposed regulations, published in the Federal Register on December 10, 1990, resolve many questions left unanswered by the statute.[191] In general, specified records directly or indirectly related to transactions between the reporting corporation and any foreign related parties must be maintained in the United States. There is a safe harbor regarding the types of records that must be kept.[192] If it agrees to deliver duplicates of original documents and certain other information to the Service within specified time periods, a reporting corporation may elect to maintain outside of the United States records not ordinarily maintained in the United States.[193] An election to maintain records outside the United States may be invalidated if there is "a clear pattern of failure to maintain or timely produce the required records."[194]

The regulations reflect the Treasury's intention to balance the need for documentation of related party transactions with the potential hardship to the taxpayer. Accordingly, the regula-

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Turro]. This problem may arise because many foreign firms operate in foreign jurisdictions that do not follow generally accepted United States accounting principles. Consequently, such companies may not ordinarily maintain the types of records required by United States auditors. *Id.*

190. I.R.C. § 6038A(a) (1990).

191. 55 Fed. Reg. 50706 (1990) (to be codified at 26 C.F.R. § 1.6038A-0 to 1.6038A-7).

192. Prop. Treas. Reg. § 1.6038A-3(b)(1), (2), (c), 55 Fed. Reg. 50706, 50713 (1990). The safe harbor rules ordinarily do not require creation of records that are not ordinarily created by the reporting corporation or related parties. The two exceptions are basic accounting records and records sufficient to produce profit and loss statements. Prop. Treas. Reg. § 1.6038A-3(c)(1), 55 Fed. Reg. 50706, 50713, 50714 (1990).

193. Congress anticipated that there would be classes of documents of sufficient importance to merit a requirement that they (or duplicates) be maintained in the United States. It suggested that other classes of documents, such as supporting information (information not directly or indirectly related to a related party transaction), would be subject to more flexible rules permitting a foreign location. STAFF OF SENATE FINANCE COMM., 101ST CONG., 1ST SESS., EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON OCTOBER 3, 1989 at 111, 114 (Comm. Print 1989) [hereinafter 1989 Senate Report]; Prop. Treas. Reg. § 1.6038A-3(c)(1), (f), 55 Fed. Reg. 50706, 50713-14, 50717 (1990).

194. Congress contemplated that certain records could be maintained outside the United States where the Service is satisfied that the records will be maintained by agreement and will be supplied promptly upon request or where records are maintained in a country in which there is an exchange of information agreement between the IRS and the tax authorities assuring IRS access to all relevant documents. On the other hand, it stated that reporting corporations should be required to maintain certain categories of documents not generally required to be kept in the United States in situations where enforcement problems are anticipated. 1989 Senate Report, *supra* note 193, at 114-15; Prop. Treas. Reg. § 1.6038A-3(f)(4), 55 Fed. Reg. 50706, 50717 (1990).

tions provide for a procedure by which a reporting corporation may negotiate and enter into an advance agreement concerning what records must be maintained.[195] In addition, reporting corporations with a small value of transactions with a related foreign party (gross payments no greater than $2,000,000 and less than ten percent of the reporting corporation's United States gross income) are not subject to the detailed documentation requirements of section 6038A.[196]

In cases involving confidential records, a related party often does not wish to relinquish control of the documents to the reporting corporation. Record maintenance rules are satisfied if the documents are merely maintained by the foreign related party in the United States or by a third party, even if they are not within the control of the reporting corporation. The reporting corporation nonetheless remains liable for the maintenance of the records.[197]

The penalty for failure to report the prescribed information or to maintain the appropriate records is $10,000[198] for each annual failure. The penalty escalates to $10,000 (with no ceiling)[199] for each thirty day period if the reporting corporation fails to comply for more than ninety days after receiving notice from the Service.[200]

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195. Prop. Treas. Reg. § 1.6038A-3(e), 55 Fed. Reg. 50716 (1990). The Treasury expects that a procedure similar to that provided for ADRs regarding transfer pricing will be developed. *See Treasury Said to Maintain "Tight Schedule" for Finalizing Foreign Recordkeeping Rules*, Daily Tax Rep. for Executives (BNA) No. 236, at G-1 (Dec. 7, 1990).

196. Prop. Treas. Reg. § 1.6038A-1(h), 55 Fed. Reg. 50706, 50710 (1990). The corporation nonetheless remains subject to the general record keeping requirements of section 6001 and the requirement that Form 5472 be filed pursuant to Prop. Treas. Reg. § 1.6038A-2, 55 Fed. Reg. 50706, 50711 (1990).

197. Prop. Treas. Reg. § 1.6038A-3(b)(3), 55 Fed. Reg. 50716, 50713 (1990). Regarding possible claims that the record maintenance requirements are inconsistent with tax treaty provisions prohibiting exchanges of information that would result in the disclosure of trade, industrial or commercial secrets, Congress indicated its belief that such concerns are adequately addressed by the current protection of confidential information provided by section 6103 of the Code. H.R. CONF. REP. No. 386, 101st Cong., 1st Sess. 595, *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS 3018, 3198 [hereinafter H.R. CONF. REP. No. 386].

198. For periods before July 11, 1989, the penalty was $1,000. I.R.C. § 6038A(d)(2) (1988).

199. For taxable years beginning in periods before July 11, 1989, there was a similar escalation clause that, like the section 6038(b)(2) provision, capped at $24,000. I.R.C. § 6038A(d)(2) (1990).

200. I.R.C. § 6038A(d)(1), (2) (1990). If the reporting corporation establishes to the Treasury Secretary's satisfaction that there was reasonable cause for the failure to fur-

There are elaborate enforcement provisions relating to record keeping requirements for transactions between related parties and the reporting corporation.[201] A substantial sanction awaits a failure to comply. If the foreign related party fails to agree to the enforcement mechanisms, the amount of any deduction claimed by the reporting corporation in connection with a transaction with a related party and the cost to the reporting corporation of any property acquired in such a transaction must be the amount determined at the "sole discretion" of the Treasury.[202] In determining the amount of the deduction or the cost of acquired property, the Treasury must consider information submitted by either party to the transaction unless it determines in its "sole discretion" that the information submitted is not sufficiently probative.[203] A court must apply the same standard of review to the Treasury Secretary's determination as it would under section 482. That determination must be sustained unless there is a showing of an abuse of discretion by the Secretary.[204]

The primary enforcement mechanism is the requirement that the foreign related party agree to nominate the reporting corporation as agent for the limited purpose of applying the summons enforcement provisions of the Code (sections 7602, 7603, 7604) in order to determine the treatment of any transac-

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nish information or to maintain records, the penalties may be eliminated. Treas. Reg. § 1.6038A-(1)(f)(3) (1990). Inability to comply with section 6038A requirements because of a foreign law civil or criminal penalty does not constitute reasonable cause. Congress intended the "reasonable cause" exception to be applied liberally to small corporations that: (1) had no knowledge of the requirements imposed by section 6038A, (2) have a limited presence in and contact with the United States, and (3) promptly and completely comply with all Service requests for documents. 1989 Senate Report, *supra* note 193, at 117.

201. I.R.C. § 6038A(e) (1990). The provisions were added for tax years beginning after July 10, 1989 by the Revenue Reconciliation Act of 1989. The Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2106 (1989).

202. I.R.C. § 6038A(e)(3) (1990).

203. H.R. CONF. REP. No. 386, *supra* note 197, at 594, *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS at 3197. Congress intends that the Treasury Secretary's determination in this regard be subject only to "limited judicial review." A taxpayer seeking judicial review bears the burden of proof by clear and convincing evidence that the Secretary abused his discretion. The court must accept as true all allegations and inferences that may support the Secretary's position. A court might overturn a determination on the grounds of improper motive or clear mistake by reference to all reasonably credible interpretations. However, a court may not substitute its own judgment for that of the Service and it must accord a high degree of deference to the Secretary's determination. *Id.*

204. H.R. CONF. REP. No. 386, *supra* note 197, at 594, *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS at 3197.

tion between the two parties.[205] The summons provisions permit the Treasury to direct production of documents and testimony.[206] If the reporting corporation fails to substantially comply with a summons in a timely manner after notice from the Secretary of the failure to comply, the sanction described above applies.[207] Similarly, if an IRS summons is quashed on the ground that the reporting corporation is unable to provide records requested, the sanction applies.[208] In order to avoid imposition of the sanction, the reporting corporation must either file a proceeding to quash a summons within ninety days after issuance of the summons or notification of the Treasury's determination that the corporation failed to substantially comply with the summons or defend a summons enforcement action brought by the Treasury.[209] A court may not quash or refuse to enforce the summons on the ground that foreign civil or criminal

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205. I.R.C. § 6038A(e)(1) (1990). An appearance by the agent will not subject the foreign related party to legal process for any purpose other than the determination of the correct treatment of a transaction between the reporting corporation and the related party. *Id.* The purpose of the provision is to ensure that a summons will be effective against foreign persons that do not do business in the United States. 1989 Senate Report, *supra* note 193, at 115. Congress expects that the Service will resort first to exchange of information provisions of tax treaties, but indicates that the Service may issue a summons instead of resorting to tax treaty provisions where necessary. Treaty provisions may be bypassed by the Service in situations where quick access to information is necessary (for example, imminent expiration of the statute of limitations). *Id.*

206. Congress has indicated that it will not summon testimony from sources located abroad unless United States-based sources are not available. H.R. CONF. REP. No. 386, *supra* note 197, at 593, *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS at 3196.

207. The applicability of the sanction depends upon the validity of the summons. Consequently, if the summons is quashed under special procedures available under section 6038A(e)(4) or is determined to be invalid in a proceeding brought under section 7604(b), the sanction is not available. I.R.C. § 6038A(e)(2), (4) (1990). In order to avoid the harsh result of the sanction, Congress has authorized the Treasury to allow, in regulations, a related party to retroactively authorize the reporting corporation to act as agent to accept service of a summons where the corporation was unaware that the transaction involved a related party. The permission for retroactive authorization involves only situations involving small or brief transactions with a party related to a related party (involving no person directly related to the reporting corporation) conducted on arm's length terms. Moreover, in exceptional circumstances, the Treasury may deem a retroactive authorization to exist. Those circumstances are limited to situations in which neither party to the transaction knew of the section 6038A relationship and all transactions were conducted on an arm's length basis and did not involve any known related party. 1989 Senate Report, *supra* note 193, at 116; *see* Prop. Treas. Reg. § 1.6038A-5(e), 55 Fed. Reg. 50706, 50720 (1990).

208. The sanction only applies if the summons is valid. *See supra* note 207.

209. I.R.C. § 6038A(e)(4) (1990). The district court's determination is a final order which may be appealed. I.R.C. § 6038A(e)(4)(C) (1990).

law will penalize compliance with an IRS summons.[210]

With regard to the contention that the provisions of section 6038A violate the nondiscrimination provisions[211] of certain United States tax treaties, Congress found no violation of any treaties. Finding that the purpose of the provision is to impose equivalent reporting obligations on United States corporations without regard to capital ownership (foreign or domestic) while recognizing the "unique tax administration problems presented where corporate stock is held by foreigners," Congress concluded that the provision does not discriminate against foreign owned United States corporations.[212] However, the dramatic difference between sanctions imposed upon United States owners of foreign corporation stock (monetary penalty and partial loss of foreign tax credit) and those imposed upon foreign owners of United States corporation stock (monetary penalty, loss of deductions or other tax attributes, and a requirement that documents be created and located in the United States) may supply a sound basis for an argument of discrimination against foreign corporations. For this reason, foreign corporations resident in a country that has a nondiscrimination clause in its tax treaty with the United States may possess persuasive grounds to urge the inapplicability of the section 6038A requirements.[213]

C. *Foreign Corporations Doing Business in the United States*

The Omnibus Budget Reconciliation Act of 1990, signed by President Bush on November 5, 1990, added new section 6038C to the Code, effective for taxable years beginning in 1991.[214] Sec-

210. 1989 Senate Report, *supra* note 193, at 119.

211. A typical nondiscrimination provision states that a national of a contracting state may not be subjected in the other contracting state to taxation that is more burdensome than the taxation to which nationals of the other state are subjected. *See* TREASURY DEPARTMENT'S PROPOSED NEW MODEL INCOME TAXATION TREATY (1981), *reprinted in* MODEL INCOME TAX TREATIES 73-77 (K. van Raad ed. 1983). Nondiscrimination provisions of United States income tax treaties are discussed in P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 186-87 (1989) [hereinafter P. MCDANIEL & H. AULT].

212. Congress found that the provisions will allow the Service to gather information regarding foreign owned corporations that was previously available regarding corporations controlled by United States persons. 1989 Senate Report, *supra* note 193, at 119; H.R. CONF. REP. No. 386, *supra* note 197, at 593, *reprinted in* 1989 U.S. CODE CONG. & ADMIN. NEWS at 3196 (Pamphlet No. 11A).

213. *See generally* P. MCDANIEL & H. AULT, *supra* note 211, at 186-87.

214. The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11315, 104 Stat. 1388 (1990).

tion 6038C simply houses in a separate provision the information reporting rules imposed upon foreign corporations engaged in a trade or business in the United States (including United States branches of foreign corporations). Those rules were previously contained in section 6038A, discussed above. The new provisions, including information reporting and record-keeping requirements, penalties and sanctions for failure to comply and judicial proceedings for reporting corporations, relating to foreign corporations are virtually identical to those governing twenty-five percent foreign-owned domestic corporations, discussed above.

New section 6038C differs, however, in two important respects. First, it will govern all foreign corporations engaged in a United States trade or business. Unlike the pre-1991 statute (governing only twenty-five percent foreign-owned foreign corporations doing business in the United States), the provisions will cover United States branches of widely held foreign corporations where no one foreign person owns twenty-five percent or more of the stock. Congress felt that the expansion was necessary to cover a broader category of transactions involving foreign corporations. Second, section 6038C expands the type of information which the Service may require a covered foreign corporation to report to include any information, to be prescribed in regulations, relating to any item not directly connected to a transaction with a related foreign party. In particular, Congress intends to require maintenance of records relating to computation of taxable income effectively connected with the conduct of a United States trade or business, including allocation and apportionment of administrative expenses, interest payments and research and development expenses and the source of personal property sales income derived from a United States office.[215]

The expanded record-keeping requirement promises to be problematic. On the one hand, Congress maintains that the appointment of a United States agent for document production requests under section 6038C will not subject the foreign corporation to legal process regarding matters other than determining the correct United States income tax treatment of transactions between the foreign corporation and a related party.[216] On the

215. H.R. Rep. No. 881, 101st Cong., 2d Sess. 322-23, *reprinted in* 1990 U.S. Code Cong. & Admin. News 2324-25 (Pamphlet No. 10C) [hereinafter H.R. Rep. No. 881].

216. H.R. Rep. No. 881, *supra* note 215, at 327, *reprinted in* 1990 U.S. Code Cong. & Admin. News at 2329.

other, any foreign corporation merely doing business in the United States is subjected to requirements that records be maintained and testimony produced in the United States, relative to matters other than related party transactions.

The expanded record-keeping requirement represents an attempt by Congress to avoid difficult questions by imposing United States standards upon businesses operating in other countries. To condition a foreign corporation's right to do business in the United States upon a willingness to accept record-keeping rules that may conflict with home country rules seems misguided since it does little to resolve the quandary of foreign firms that must also operate within the confines of the law in jurisdictions outside of the United States. Congress contends, nonetheless, that the record-keeping requirement is not burdensome when one considers that the other matters for which records must be maintained, and testimony produced, are those definitely related to the foreign corporation's United States business. Congress fails to consider, however, that section 6038C appears to be an attempt to legislate United States rules on a worldwide basis.[217]

In support of the expanded rules is the assertion that the expanded record-keeping requirements are essential to the government's ability to obtain crucial records from United States branches of foreign corporations that are often unavailable because of a variety of impediments. The impediments include differing record-keeping practices in the foreign home jurisdiction, the difficulty of enforcing compliance with a summons when corporate officials are located outside of the United States, and the effect of foreign law provisions limiting IRS access to information located in a foreign country. Congress felt it appropriate to condition the computation of effectively connected taxable income upon the compliance of the foreign corporation with the documentation requirements designed to result in the availability of information sufficient to permit the Service to properly analyze the corporation's income computations.[218] Hopefully, in

217. Congressional assertion of might in this area is similar to its willingness to override treaty obligations unilaterally through enactment of legislation without consultation of treaty partners. For a discussion of the overriding of treaties by the United States, see P. MCDANIEL & H. AULT, *supra* note 211, at 173-75.

218. H.R. REP. No. 881, *supra* note 215, at 322-23, *reprinted in* 1990 U.S. CODE CONG. & ADMIN. NEWS at 2324-25.

regulations to be issued,[219] the Treasury will seek to balance the need of multinational businesses to operate within the confines of a variety of legal regimes with the United States need to enhance revenue.

D. *Section 367 Transfers*

Transfers of property by a United States person to a foreign corporation in a transaction described in section 367 must be reported to the Service.[220] The information return must be filed with the transferor's tax return for the taxable year of the transfer. The return must identify the parties to the transfer, describe the transfer and related transactions, describe the consideration received, and describe the fair market value and adjusted basis of the property and the nature of the use of the property by the transferee.[221]

If intangible property is transferred, a calculation of the annual deemed payment under section 367(d) must be made and the transferor must describe any other intangible property sold or licensed to the transferee foreign corporation.[222] Also in connection with transfers of intangible property, the transferor must report any subsequent transfers of the intangible property by the transferee or any disposition by the transferor of any stock of the transferee.[223]

If the transferor fails to report in a timely manner or provides false or inaccurate information, a penalty equal to twenty-five percent of the gain realized on the exchange is imposed.[224] The penalty will not be imposed if the transferor establishes that failure to report was due to reasonable cause and not willful

219. A section 6038C regulations project is already under way. *See* Turro, *supra* note 189, at 948. It is expected that those regulations will adjust the rules for 6038A to reflect the different relationship between "an entity and its branch." *Id.* To the extent that the rules of sections 6038A and 6038C are similar, the proposed regulations under section 6038A apply. Prop. Treas. Reg. § 1.6038C-1, 55 Fed. Reg. 50706, 50721 (1990).

220. I.R.C. § 6038B (1990).

221. Treas. Reg. § 1.6038B-1T(c) (1990). The information must be reported on Form 926. Treas. Reg. § 1.6038B-1T(b) (1990).

222. Treas. Reg. § 1.6038B-1T(d)(1) (1990).

223. Treas. Reg. § 1.6038B-1T(d)(2) (1990).

224. I.R.C. § 6038B(b)(1) (1990). Treas. Reg. § 1.6038B-1T(f)(1) (1990). In addition, if the reporting requirements are not met, the transferred property will not be considered to be eligible for the special rules for property transferred for use in the active conduct of a trade or business of the foreign transferee. Treas. Reg. § 1.6038B-1T(f)(1) (1990).

neglect.[225]

IV. ACCURACY-RELATED PENALTIES AND SECTION 482

A different kind of enforcement mechanism is the imposition of an accuracy-related penalty for failure to adhere to the rules. The Omnibus Budget Reconciliation Act of 1990[226] amended an existing provision in order to provide two new penalties for substantial valuation misstatements and gross valuation misstatements in connection with section 482 transfers. Amended section 6662(e) imposes a sizeable penalty equal to twenty percent of any underpayment attributable to a substantial valuation misstatement.[227] A substantial valuation misstatement includes two situations relevant to section 482 transactions: (1) instances in which the price for any property or services or the use of property in a section 482 transaction is two hundred percent or more, or fifty percent or less, than the amount determined under section 482 to be the correct price[228] and (2) instances in which the "net section 482 transfer price adjustment" exceeds $10,000,000.[229] A "net section 482 transfer price adjustment" is the net increase in taxable income for a taxable year resulting from section 482 adjustments in the price for any property, services or for the use of the property.[230] Congress intends that the provisions be construed broadly to include consideration of all kinds, including purchase prices, fees for services, royalties, interest, and rents.[231]

The net section 482 adjustment may relate to the corporation involved in the section 482 transaction or a United States shareholder of the corporation.[232] In determining whether an ad-

225. I.R.C. § 6038B(b)(2) (1990).

226. The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (1990).

227. I.R.C. § 6662 (b)(3), (e)(1); The Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11312, 104 Stat. 1388 (1990). There is a *de minimis* rule excluding imposition of the 20% penalty where the underpayment does not exceed $10,000 (or $5,000 in the case of S corporations or personal service corporations). I.R.C. § 6662(e)(2) (1990).

228. I.R.C. § 6662(e)(1)(A) (1990).

229. I.R.C. § 6662(e)(1)(B) (1990).

230. I.R.C. § 6662(e)(3)(A) (1990). Amounts carried to the taxable year from another taxable year are excluded. *Id.*

231. H.R. CONF. REP. No. 964, 101st Cong., 2d Sess. 1075, *reprinted in* 1990 U.S. CODE CONG. & ADMIN. NEWS 2780 (Pamphlet No. 10C) [hereinafter H.R. CONF. REP. No. 964].

232. H.R. CONF. REP. No. 964, *supra* note 231, at 1075-76, *reprinted in* 1990 U.S.

justment exceeds $10,000,000, certain amounts are disregarded. The disregarded amounts are (1) any net increase attributable to a price redetermination where the taxpayer's price determination was in good faith and supported by reasonable cause and (2) any net increase attributable to a transaction solely between foreign corporations (a so-called "foreign-to-foreign" transaction) unless the transaction affects the determination of income effectively connected to a United States trade or business.[233] If the net section 482 adjustment exceeds $10,000,000 independently of a "foreign-to-foreign" transaction, any net increase attributable to the "foreign-to-foreign" transaction is subject to the penalty unless the reasonable cause or good faith exception generally applicable to all section 6662 penalties applies.[234]

A gross valuation misstatement occasions a more hefty penalty equal to forty percent of the resulting underpayment. A gross valuation misstatement occurs where the price for any property, service, or use of property in a section 482 transaction is four hundred percent or more of or twenty-five percent or less than the correct price determined under section 482.[235] It also occurs where the net section 482 transfer price adjustment for the year exceeds $20,000,000.[236] Presumably, the *de minimis* exception and the disregard of certain amounts in determining whether the threshold amount for a net price adjustment is exceeded, described above in connection with the substantial valuation misstatement, are applicable to gross valuation misstatements.[237]

CODE CONG. & ADMIN. NEWS at 2780-81 (Pamphlet No. 10C).

233. I.R.C. § 6662(e)(3)(B) (1990).

234. H.R. CONF. REP. No. 964, *supra* note 231, at 1076, *reprinted in* 1990 U.S. CODE CONG. & ADMIN. NEWS at 2781 (Pamphlet No. 10C). Any portion of an underpayment attributable to the reasonable cause of a taxpayer acting in good faith is not considered in determining whether the $10,000,000 threshold amount is reached under section 6662(e)(1)(B)(ii). I.R.C. § 6662(e)(3)(B)(i) (1990). Moreover, section 6664(c) of the Code provides a reasonable cause exception for all penalties described in section 6662. Consequently, even if the threshold amount were reached independently of a "foreign to foreign transaction," any portion of an underpayment attributable to reasonable cause would not be subject to the section 6662(b)(3) penalty for substantial valuation misstatements.

235. I.R.C. § 6662(h)(2)(i), (ii) (1990).

236. I.R.C. § 6662(h)(2)(iii) (1990).

237. The legislative history of the 1990 Act is silent on this point. The reference to section 6662(e) (defining the term "substantial valuation misstatement" and describing the exceptions) in the definition of gross valuation misstatements appears to indicate adoption of exceptions. Presumably, if Congress had intended to reject the exceptions, it would have incorporated only section 6662(e)(1) into the gross valuation misstatement

The valuation misstatement penalties appear to be an appropriate deterrent to transfer pricing manipulation. Moreover, there is no unwarranted negative effect upon multinational businesses. Consequently, the penalties are appropriate mechanisms for the enforcement of United States transfer pricing rules.

V. Conclusion

The issues raised by international transfers of intangible property are complex. There is no simple solution to problems encountered in the course of establishing acceptable rules that are convenient for taxpayers that operate across national borders. The United States has taken a major step in proposing new transfer pricing methodology that is founded upon economic analysis of transactions. It has attempted to make the methodology convenient for taxpayers by proposing an advance ruling procedure that will enable advance determination of appropriate prices. In addition, enforcement mechanisms have been adopted that will insure implementation of United States rules. Finally, it has indicated a desire to cooperate with other countries to resolve issues raised by conflicting national rules. While flaws in some of the enforcement mechanisms, especially the information reporting rules for United States branches, exist, progress generally has been made. Developments in this area in the near future should include refinement of current doctrine to achieve rules that do not impede multinational business.

Postscript

At the time this Article went to Press, the Service finalized the advance ruling procedures in Rev. Proc. 91-22, 1991-11 I.R.B. 11 (March 18, 1991). See supra note 100.

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provisions.