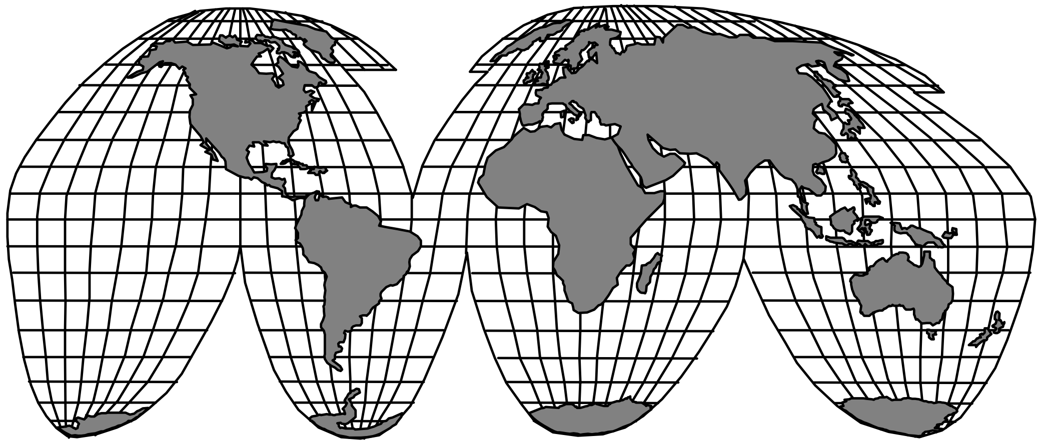

Report on the Application and Administration of Section 482

Office of the Assistant Commissioner (International)
Office of the Assistant Commissioner (Research & Statistics of Income)
Office of the Associate Chief Counsel (International)

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IRS

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INTRODUCTION AND EXECUTIVE SUMMARY

This report responds to the Congressional direction made in the Conference Report to H.R. 4328, Omnibus Consolidated and Emergency Supplemental Appropriations Bill Act, 1999, Pub. L. 105-277, 105th Cong.,2d Sess. 1486 (1998). The mandate provided as follows:

> TRANSFER PRICING
>
> The Conferees are concerned about the Nation's loss of revenue as a result of foreign corporations employing transfer pricing. Transfer pricing, utilized by State Trading Enterprises, reallocates items of income and deduction among entities under common control. Reallocation of the income and deduction results in minimizing the U.S. tax of foreign corporations' U.S. affiliates. Since the foreign parent corporations do not normally do business in the United States, their income is completely free from U.S. tax.
>
> To ensure the Internal Revenue Service is vigorously administering section 482 of the Internal Revenue Code, which empowers the Secretary of the Treasury to distribute, apportion, and allocate items of gross income and deduction between the parent corporations and their U.S. affiliates, the conferees direct the Internal Revenue Service to review and report to Congress, no later than six months after enactment of this Act, on the following issues: IRS's loss of revenue as a result of transfer pricing; detailed information on IRS's administration of section 482 to distribute, apportion, and allocate items of gross income and deduction; and recommendations on how to improve the collection of revenue from trading enterprises.

To address the foregoing three issues, this report provides estimates of the section 482 gross income tax gap (Chapter 1), describes legal and administrative developments in promoting compliance under section 482 (Chapters 2 through 7), and offers recommendations and conclusions (Chapter 8). The report reviews developments since the previous report on similar subject matter made at the direction of the Congress pursuant to section 11316 of the Omnibus Reconciliation Act of 1990. Report on the Application and Administration of Section 482 (April 1992) (1992 report).[1]

Section 482 authorizes the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers in order to prevent evasion of taxes or clearly to reflect their income. Application of section 482 to multinational operations may involve a wide range of technical and factual issues. For example, if a domestic distribution subsidiary buys goods from its foreign parent for resale to unrelated parties, what markup should it earn? Or, if an offshore subsidiary uses patents and manufacturing know-how belonging to its U.S. parent, what rate of royalty should the parent earn for permitting the subsidiary to use its intangible assets? In general terms, section 482 asks whether prices charged by one affiliate to another in an intercompany transaction involving the transfer of goods, services, or intangibles yield results for the transaction that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. This standard of a taxpayer dealing at arm's length with an uncontrolled taxpayer, known as the arm's length standard, has been incorporated in regulations under section 482 or its predecessors for over 60 years.

The IRS's goal in administering section 482 is to ensure that each controlled taxpayer reflects its true taxable income from intercompany transactions as determined under the arm's length standard. For example, if the IRS determines that a foreign related party overcharged its U.S. affiliate for goods or services, IRS may adjust the transfer price downward, thereby increasing the U.S. party's taxable income. If the foreign country in question agrees that the transfer prices were too high, it may agree to make a correlative adjustment decreasing the income of the foreign affiliate. However, if the foreign country disputes the validity of the adjustment, and declines to make a correlative adjustment, some portion of the income will be subject to double taxation, once in the foreign country and once in the United States. The common adoption of the arm's length principle in all 50 of our current income tax treaties (with the one exception of that with the former U.S.S.R.) and in the

[1]For a prior corporate income tax gap estimate, see Estimates of the Income Tax Gap Among Foreign-Controlled Domestic Corporations, Department of the Treasury, Internal Revenue Service Compliance Research Division (June 8, 1994).

guidelines of the Organization for Economic Cooperation and Development (OECD) minimizes the potential for double taxation and provides a basis to resolve double tax cases by mutual agreement through the competent authority process under the treaties.

A principal obstacle to past administration of section 482 was the lack of contemporaneous attention given by taxpayers to complying, and documenting compliance, with the arm's length standard in transfer pricing. Typically taxpayers did not take the arm's length standard into account for purposes of reporting their taxable income from intercompany transactions. When IRS examiners audited the returns, they generally found that no analysis or documentation existed to explain the appropriateness of transfer prices. Indeed, taxpayers only began their attention to the transfer pricing issue during the audit process, several years after the period in which the transactions took place. With hindsight, taxpayers and examiners often had the incentive to adopt positions that arguably supported extreme results and led to protracted disputes. This report sets forth the statutory, regulatory, and administrative initiatives that have been adopted to address these problems. The overall aim has been to shift the focus from after-the-fact audit and litigation of transfer pricing controversies to encouragement of upfront taxpayer compliance and advance resolution of transfer pricing issues.

Chapter 1 presents the Internal Revenue Service's estimates of the gross income tax gap related to section 482 of the Internal Revenue Code. It includes estimates for both foreign-controlled corporations (FCCs) and for U.S.-controlled domestic corporations (non-FCCs). Chapter 1 also provides an analysis of the available compliance data in an effort to detect compliance trends associated with important legal developments effective in 1994. The tax gap estimates are based on audit adjustments to income from IRS International Examiner operational examinations of Form 1120 tax returns completed during fiscal years 1996 through 1998. The report also describes some potential limitations in the data and in the analysis that could result in the estimates' understating or overstating the "true" tax gap. Subject to these important limitations, the average annual section 482 gross income tax gap is estimated to amount to $2.8 billion. This includes a $2.0 billion gap attributable to FCCs and a $0.8 billion gap attributable to non-FCCs. These numbers are smaller than some of the estimates of the section 482 tax gap made by others. These other estimates, however, are based on estimation methodologies quite different from the audit-adjustment approach used in this report.

Chapter 2 summarizes the guidance the IRS has promulgated on the application of the arm's length standard. Principal in this category are the final section 482 regulations issued in 1994. In addition to this substantive guidance, the IRS, with the strong backing of Congress, has moved to ensure that taxpayers apply the arm's length standard as provided for in the transfer pricing regulations at the time they file their original return and that taxpayers have contemporaneous documentation establishing such compliance. This contemporaneous documentation is provided for in section 6662(e), as amended in 1993. The IRS issued temporary regulations in 1994 and final regulations in 1996 implementing this provision. The incentive for taxpayers to undertake these compliance responsibilities are the penalties that are otherwise applicable under section 6662(a) and (h) in the event a taxpayer's transfer pricing is adjusted by the IRS.

Chapters 3 through 5 focus on administrative developments in Examination, Appeals, and Competent Authority relating to the resolution of transfer pricing issues. Significant examination resources are committed to transfer pricing audits. There are approximately 650 international examiners (IEs) who devote about half their time to examining transfer pricing issues. The Office of the Assistant Commissioner (International) instituted the International Field Assistance Specialization Program (IFASP) in 1991. IFASP includes a team of four senior specialists who travel nationwide to provide transfer pricing expertise and assistance to IEs, IE managers, CEP managers, and economists on particular transfer pricing cases. As for other tax issues, the IRS makes a conscientious effort to settle section 482 cases in examination. Most cases involving proposed section 482 adjustments, however, are settled by Appeals. Appeals is always striving to develop innovative dispute resolution mechanisms. In recognition of the potential double tax dimension of many transfer pricing cases, a simultaneous procedure has been inaugurated for early joint consideration of these matters by Appeals in conjunction with the U.S. competent authority. The procedures for requesting assistance from the U.S. competent authority were generally revised and updated in 1996. The competent authority process continues to achieve substantial relief for taxpayers from double taxation by both the United States and its treaty partners. Treasury and the IRS have joined treaty partners in the OECD to build a worldwide consensus on the application of the arm's length principle and on the taxpayer's responsibility to contemporaneously document compliance. The product of this collaborative effort were the 1995 OECD Transfer Pricing Guidelines. Major U.S. trading partners have subsequently adopted legislation and other guidance implementing the approach of the Guidelines. The United States continues to actively contribute to the ongoing work on these guidelines.

Chapter 6 addresses the Advanced Pricing Agreement (APA) program which IRS encourages taxpayers to use to provide certainty and advanced resolution of potential transfer pricing disputes. An APA is a cost effective approach to protect both against section 482 adjustments and section 6662(e) penalties. APAs may be unilateral or bilateral. A unilateral APA is an agreement for a prospective period of time between the taxpayer and the IRS on the appropriate transfer pricing method (TPM) for the transactions at issue. With this approach, there is no guarantee that the foreign country's taxing authority will agree that the TPM is correct. A bilateral APA that combines an agreement between the taxpayer and the IRS on a particular TPM, with an agreement (pursuant to the competent authority process under income tax treaties) between the United States and foreign taxing authority regarding the propriety of the TPM, may also avoid the potential double tax problems. As of the fiscal period ended September 30, 1998, 164 APAs have been concluded with another 186 under negotiation. These APAs span a wide range of industries and involve numerous cross-border transactions including sales of tangible property and transfers of intellectual property. Roughly half of the APAs completed to date have been bilateral. Both unilateral and bilateral APAs may also provide that the agreed-upon TPM be "rolled back" to resolve similar issues for past years under audit.

Chapter 7 discusses developments in the litigation of section 482 cases since 1992. A sustained commitment to the successful litigation of section 482 cases is an integral part of the IRS tax compliance effort. Since 1992, the IRS has expanded programs to ensure earlier identification of compliance issues in cross-border cases generally, better development of the cases, and more efficient allocation of limited litigation resources. These strategies have borne fruit in the form of successful litigation of novel issues related to section 482, including precedent upholding enforcement tools enacted to assist in the examination of cross-border related party transactions. In the first case interpreting section 6038A(e), the Tax Court in ASAT, Inc. v. Commissioner, 108 T.C. 147 (1997), upheld the IRS penalty determination of claimed related party deductions as the result of the taxpayer's noncompliance with section 6038A. In DHL Inc., and Subsidiaries v. Commissioner, T.C. Memo. 1998-461, 76 T.C.M. (CCH) 1122**,** the Tax Court determined that petitioner understated its royalty income and misstated its gains from sale of petitioner's trademark in 1992, without reasonable cause, resulting in application of accuracy related penalties under section 6662, including a penalty of 40% of the deficiency attributable to the gross valuation misstatement of the trademark value. DHL, Inc., and other recent cases illustrate the difficulties faced by the IRS in determining an appropriate reallocation and the necessity to continue to defend such reallocations when information is not forthcoming without litigation. Although the reallocations sustained by the Court were greatly reduced from that initially determined by the IRS, substantial adjustments to the position taken on the return were sustained nevertheless. Finally, knowledge gained in litigation has informed the development of related intercompany issues in the context of the possessions and the withholding at source regimes and helped shape regulatory guidance.

Chapter 8 concludes the IRS intends to continue to pursue its five-part strategy to improve the administration of section 482. Thus, the IRS plans a combination of section 482 guidance, promotion of upfront compliance with the arm's length standard, strengthening the international consensus on transfer pricing guidance and compliance, advanced resolution of transfer pricing issues in the APA Program, and strategic management of section 482 issues in litigation. Chapter 8 also recommends that the IRS consider improving its section 482 tax gap and section 482 compliance trend measures and offers two strategies for such a program. With regard to the Field, Appeals, Competent Authority, and the Advanced Pricing Agreement program described in Chapters 3 through 7, the IRS Restructuring and Reform Act of 1998 has prompted the most significant reorganization of the IRS in 40 years. This modernization effort at this time is a work in process and the available information must be considered preliminary. As a consequence, it is difficult to develop recommendations with regard to the IRS organization and section 482. The reorganization is expected to alter the existing structure in many significant ways. The preliminary indications are that the reorganization will take appropriate account of the particular functions of the International Examiners, Appeals, Competent Authority, and the Advance Pricing Agreement program. The IRS's focus on section 482 compliance will not be lost and should, in fact, benefit from the new organization.

CHAPTER 1: ESTIMATES OF THE SECTION 482 GROSS INCOME TAX GAP

I. <u>Summary</u>

This report presents the Internal Revenue Service's estimates of the gross income tax gap related to section 482 of the Internal Revenue Code. It includes estimates for both foreign-controlled corporations (FCCs) and for U.S.-controlled domestic corporations (non-FCCs). This report also provides an analysis of the available compliance data in an effort to detect compliance trends associated with two important legal developments effective in 1994. The tax gap estimates are based on audit adjustments to income from IRS International Examiner (IE) operational examinations of Form 1120 tax returns completed during fiscal years 1996 through 1998. The report describes some potential limitations in the data and in the analysis that could result in the estimates' understating or overstating the "true" tax gap. Subject to these important limitations, the average annual section 482 gross income tax gap is estimated to amount to $2.8 billion. This includes a $2.0 billion gap attributable to FCCs and a $0.8 billion gap attributable to non-FCCs. These numbers are not a measure of the revenue loss associated with section 482 noncompliance for several reasons including the fact that most (61%) of the noncompliance identified in this analysis has been picked up on audit. In addition, the audit-adjustment methodology used in this report is not necessarily reflective of the relative compliance of FCCs as compared to non-FCCs. The tax gap numbers are smaller than some of the estimates of the section 482 tax gap made by others. These other estimates, however, are based on estimation methodologies quite different from the audit-adjustment approach used in this report.

II. <u>Introduction</u>

This report presents the Internal Revenue Service's estimates of the gross income tax gap attributable to corporations (both foreign-controlled and U.S.-controlled) engaged in international transactions covered under section 482 of the Internal Revenue Code. The gross income tax gap is defined as the amount of tax that is not paid voluntarily and timely. The gross gap is divided into the following three components, which reflect the basic nature of the noncompliance: (1) the underreporting gap, (2) the nonfiling gap, and (3) the underpayment gap. The underreporting gap is the amount of tax liability that is not reported voluntarily by taxpayers who voluntarily and timely file returns. The nonfiling gap is the tax owed by taxpayers who do not voluntarily file returns. The underpayment gap is the amount of tax liability that taxpayers voluntarily report but do not pay voluntarily and timely.[2]

This report does not directly measure the "IRS's loss of revenue as a result of transfer pricing," as requested by the Conference Report. This "loss of revenue" is sometimes termed the "net" tax gap. The $2.8 billion tax gap reported in this study is the "gross" tax gap, that is, it is an estimate of both the noncompliance identified on audit and the noncompliance that would have been identified if the IRS had audited every corporate tax return with a potential

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[2]<u>See</u> IRS Publication 1415 (Rev. 4-96), <u>Federal Tax Compliance Research: Individual Income Tax Gap Estimates for 1985, 1988, and 1992</u>, p. 2.

section 482 issue. The $2.8 billion gross tax gap includes approximately $1.7 billion identified on audit by the IEs and $1.1 billion that would have identified if all tax returns were examined by IEs.

This report attempts to estimate the "gross" tax gap and not the "net" tax gap. Among the more important reasons is that the available data on section 482 compliance are derived from operational audits and do not include any information on assessments or collection. A second reason is that, from a tax administration perspective, noncompliance that is identified on audit is in many ways as significant as noncompliance that goes undetected. Both types of noncompliance are indicative of taxpayers who through mistake, neglect, or intention have erred on their returns. Both types of noncompliance are of concern to the IRS.

It is important to note that neither the $1.7 billion identified on audit nor the $1.1 billion that could have been identified represent tax dollars actually collected or dollars potentially collected. This is because under the methodology of the report, as discussed below under the heading "caveats", the tax gap figure represents only proposed adjustments. Its does not take into account possible settlements that may have occurred at Appeals or in litigation, nor any ultimate disposition of a litigated dispute. In addition, the tax gap figure assumes an effective tax rate of 34% and thus does not take into account possible lower effective tax rates due to net operating loss carryovers, tax credits, and other factors. Finally, the figure assumes 100% collection, although this may be a plausible assumption for the international businesses under study.

The effort to develop comprehensive and reliable section 482 tax gap estimates is made difficult by the absence of comprehensive data. Prior IRS tax gap estimates, especially of the individual income tax gap, generally have been based on data from special examinations conducted under the Taxpayer Compliance Measurement Program (TCMP), supplemented by information from other special compliance studies. In developing the estimates in this report, we made limited use of the results of the most recent TCMP corporation examinations, which were restricted to tax year 1987 returns of small corporations. However, the estimates in this report were primarily developed using a methodology that relies heavily on data from operational examinations (that is, examinations not conducted under TCMP).[3]

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[3]The Taxpayer Compliance Measurement Program (TCMP) has been IRS's primary source of information on taxpayer compliance. Tax returns examined under this program are randomly selected and subject to line-by-line review by IRS examiners. The information collected as a result of these examinations provides detailed line-by-line data on amounts taxpayers reported on their returns and on what

Since these data provide information only on the income not reported voluntarily by filers of returns, the estimates in this report necessarily reflect only the underreporting gap.[4]

This report's tax gap estimates are based on data from International Examiner operational examinations of Forms 1120, "U.S. Corporation Income Tax Return." These Forms 1120 include returns filed by FCCs and returns filed by non-FCCs. If a foreign corporation conducts business in the U.S. through a U.S. subsidiary corporation, then the subsidiary files a Form 1120 and indicates the extent of its foreign ownership on its Form 1120. FCCs are defined to be corporations with at least 25 percent foreign ownership.

IRS examiners believed they should have reported. The random selection readily enables the development of estimates of noncompliance for the population of returns from which the TCMP sample was drawn. The line-by-line review provides a comprehensive picture of noncompliance.

The random selection and line-by-line review features of the TCMP examinations are two important differences between TCMP and regular operational examinations. Returns selected for examination under operational programs are selected based on return characteristics that suggest a potential for a tax change. Operational examinations also are much narrower in focus than TCMP examinations, generally focusing on issues identified during classification of the returns and/or initial review by the examiners. These characteristics of operational examinations make it difficult to develop tax gap estimates from operational examinations. Our methods for doing so are discussed later in the report, as are several caveats concerning the limitations of the data and the methodology.

[4]In our prior estimates of the income tax gap associated with all corporations, the underreporting gap has accounted for nearly all of the gross income tax gap.

A number of simplifying assumptions had to be incorporated into the estimation methodology in order to work with the available data. Because of various limitations involving the data and methodology, the estimates are subject to a number of potentially serious biases. For example, to the extent that examinations do not detect all noncompliance, our examination-based approach may tend to underestimate the magnitude of the tax gap. Conversely, because our tax gap estimates are not based on actual tax assessment data, but are instead generated by applying marginal tax rates to income adjustment data, our approach may tend to overestimate the magnitude of the tax gap. Important caveats regarding the estimates are discussed in more detail below. Given the assumptions that had to be employed in generating these estimates, the estimated tax gap values presented here should be used with considerable caution.

Finally, in a separate analysis of the same type of data used to develop the tax gap numbers, this report presents an analysis of proposed section 482 adjustments for the two taxable-year periods ending before and on or after December 31, 1994. This analysis seeks to identify compliance trends that may relate to two of the more significant legal developments described in Chapter 2, i.e., the enactment of the contemporaneous record keeping requirements under section 6662(e) in 1993 and the promulgation of the final section 482 regulations in 1994. Unfortunately, the analysis is inconclusive.

III. <u>Data</u>

As noted above, the estimates presented in this report are based on data obtained from operational examinations. Our section 482 tax gap estimates were generated from a database comprising results of all Form 1120 International Examiner examinations completed during fiscal years (FY) 1996, 1997, and 1998.

The database used to estimate the section 482 tax gap included results for International Examiner examinations of 8,210 Form 1120 returns completed during FY96-98. However, the returns in this database did not comprise a random sample of all corporations. Instead, they were returns that were selected for audit on the basis of tax change potential after being referred to International because they had international characteristics. Of the 8,210 Form 1120 examinations, 2,233 were completed in FY 96, 2,368 in FY97, and 3,609 in FY 98. The examinations completed in FY96 produced 7,794 income adjustments, while those completed in FY97 produced 7,193 adjustments, and those completed in FY98 produced 9,659 adjustments. Not all of these adjustments to income were section 482 adjustments, however. Section 482 adjustments came to 2,077 for FY96, 1,825 for FY97, and 2,135 for FY98. Data from the three years of examinations in the database were pooled to produce "average annual" section 482 tax gap estimates for FY96-98. This helped to moderate the effect on the estimates of year-to-year fluctuations in examination results.

A slightly expanded database of International examinations was used to measure section 482 compliance trends for taxable years ending pre-and post-December 31, 1994, the effective date of the new section 6662(e) penalty which promotes contemporaneous documentation. To the database described in the preceding paragraph, additional examinations were included from FY99 through March 8, 1999.[5] In addition, the data were organized by tax return and not adjustment. For purposes of this compliance analysis, the database included 3,033 tax returns with section 482 adjustments. Of these, 1,624 returns were for taxable years ending prior to December 31, 1994 and 1,409 returns were for taxable years ending December 31, 1994 and later.

IV. Methodology

Our basic approach to estimating the section 482 income tax gap involved expanding the operational examination results in our database to the entire Form 1120 population and converting the resulting estimated income adjustment amounts to tax gap estimates. Specifically, our estimation methodology involved four steps. In Step 1, database income adjustment amounts were summed (separately for each of the three fiscal years of data in the database) by industry group, asset size class, and type of corporation (FCCs vs. non-FCCs). In Step 2, these database income adjustment sums were expanded to the total population using separate expansion ratios for each of the three sizes of corporations.[6] These expansion ratios were necessary because the completed International Examiner operational examinations comprising our database did not include the entire Form 1120 population. In Step 3, the expanded income adjustment amounts were converted to tax gap estimates by applying an average marginal corporation income tax rate of 34 percent. Finally, in Step 4, the overall tax gap estimates for each of the FYs 1996-1998 were averaged together to produce average annual section 482 tax gap estimates for FY96-98.

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[5] In addition, the data included some non-corporate tax returns; however, these non-corporate returns represent only 2% of the 3,033 returns.

[6] The expansion ratio for small corporations was 9.16, for mid-size corporations 4.58, and for large corporations 1.00.

In the next section, we discuss several biases in the tax gap estimates. These biases are quite severe. The estimates should be regarded as tentative and subject to substantial revision when better data are available. Nevertheless, it is conceivable that, even though the level of the transfer pricing tax gap is very uncertain, changes in transfer pricing compliance could be discerned by using the same type of data and the same methodology with returns for groups of taxable years. To learn whether that is possible, we analyzed data for certain taxable years ending before December 31, 1994 and those ending December 31, 1994 and later in an effort to determine whether the enactment of the contemporaneous record keeping requirements under section 6662(e) and the final section 482 regulations issued in 1994 have affected the results of IE examinations. Even if we find significant changes, interpreting them would be difficult since a myriad of possible differences–in IRS's examination program, in economic conditions, and in the sources of bias–would have to be accounted for before the changes in examination results could be confidently attributed to changes in taxpayer behavior. In spite of these problems, we are presenting the results of preliminary analysis of these data to provide additional information on this issue.

To test whether examination results have been affected, we studied two groups of IE examinations. The first group is examinations of tax returns for taxable years ending December 31, 1992 to November 30, 1994 that closed during the twelve month period ending February 1, 1997. The second group is examinations of tax returns for taxable years ending December 31, 1994 to November 30, 1996 that closed in the twelve month period ending February 1, 1999. The twelve month period ending February 1, 1999 was selected because it contains the latest available data. The twelve month period ending February 1, 1997 is the comparable period for the examinations of the earlier set of taxable years. The results of this analysis are presented in Appendix B. For convenience, the first group described above is identified as the "tax period grouping 1992 and 1993;" the second group is identified as the "tax period grouping 1994 and 1995." The Appendix also contains information on the total and average number of hours devoted by IEs to the returns in each group. These hours relate to all issues worked by the IEs, not just section 482.

The two groups were chosen because they represent examinations of returns from taxable years immediately before and after the significant legal changes and that closed during comparable periods in the audit stream. This methodology attempts to control for factors that may distinguish examinations of differing taxable years that close during a particular fiscal year. It is possible, for example, that simpler cases with relatively smaller adjustments close relatively earlier. It is important, therefore, to compare the results of closed examinations of post-1993 returns with the results of examinations of pre-1994 returns that closed at the same stage of the examination cycle.

V. Caveats

Due to limitations involving the data and the methodology that were used in their development, the IRS estimates of the section 482 tax gap in this report are subject to potential biases and should not be regarded as definitive. The most important of these potential biases, and their likely directions, are indicated below. These potential biases should be kept in mind while interpreting the estimates.

First, the estimates are probably biased downward because they are ultimately based on data from operational examinations, and evidence suggests that operational examinations do not uncover *all* noncompliance. As explained above, this is because operational examinations are typically not comprehensive examinations of all potential items on a tax return; instead, examiners tend to focus on a limited number of pre-identified issues.[7] Furthermore, due to lack of information, time constraints, etc., examiners may not necessarily identify all the noncompliance associated with the items they do examine.[8] Our examination-based approach, therefore, may tend to understate the true magnitude of the section 482 tax gap. This could be a significant source of bias in our analysis.

[7] See footnote 3, supra.

[8] Some IRS tax gap estimates, especially those based on TCMP data, have dealt with this bias by applying "multiplier" factors to certain unreported income (see IRS Publication 7285 (3-88), Income Tax Compliance Research: Gross Tax Gap Estimates and Projections for 1973-1992, pp. 13-14). Lack of appropriate data precluded such an approach here.

Another major source of uncertainty in the estimates is our Step 2 methodology for expanding the database results to the entire population. We did this by using separate coverage expansion factors for each of the three corporation size classes, 9.16 for small corporations, 4.58 for mid-size corporations, and 1.00 for large corporations. In the case of large corporations, we assumed that the entire population is examined, and hence no coverage expansion factor was used for large corporations. Our assumption of 100 percent examination coverage is probably a slight overstatement, however, biasing the estimates downward for large corporations. In the case of small corporations, only a small proportion of the entire population of returns is examined, and the returns that are examined are not representative of the entire population of small corporations. We controlled for this fact in calculating our small corporation expansion factor by comparing TCMP compliance estimates for the entire population of small corporations to IRS operational audit results for small corporations that were examined.[9] Due to the imprecision involved in comparing tax year TCMP data to fiscal year operational data, our judgment is that this probably resulted in a slight upward bias for small corporations.[10] In the case of mid-size corporations, for which we had no TCMP results, we assumed a coverage expansion factor exactly half as large as that for small corporations. This is consistent with the fact that examination coverage among mid-size corporations is considerably greater than among their small counterparts, but nevertheless our mid-size corporation factor is inherently much more uncertain than our factor for small corporations.

A third caveat relates to the relevance of the analysis below the level of the totals. In particular, the report finds that $2,013 million ($2.0 billion) of the tax gap is attributable to FCCs out of a total tax gap of approximately $2.8 billion. Of this FCC subtotal, $858 million ($0.9 billion) is attributable to large corporations and was all identified on audit of these large FCCs. With respect to

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[9]The numerator of our expansion ratio is the TY87 TCMP estimate of total tax understatement (plus penalties) by all small corporations. The denominator is the average annual amount of proposed deficiencies (including penalties) on all small corporation examinations closed in fiscal years 1989 and 1990; it is an estimate of the amount of tax deficiencies and penalties proposed in operational examinations for small corporations for TY87. The coverage expansion factor for small corporations of 9.16 means that, for tax year 1987, the TCMP study estimated that small corporations owed an aggregate amount of additional taxes and penalties that was approximately nine times as large as the amount identified in operational examinations.

[10]Another potential source of bias has to do with the fact that our expansion ratio is based on <u>all</u> small corporation noncompliance, not just section 482 noncompliance. However, we have no <u>a priori</u> basis for judging the direction in which this would bias our estimates.

the remaining $1,155 million ($1.2 billion) which is attributable to small and mid-size FCCs, the magnitude of this amount is to a considerable degree a consequence of the heavy focus on FCCs among small and mid-size taxpayers by IEs. Since 1992, in response to Congressional concerns that effective tax rates of FCCs were lower than U.S.-controlled domestic corporations, the IRS has focused significant audit resources on small and mid-size FCCs. This focus is demonstrated in the following table which shows that the IRS during the period FY95 to FY98 devoted between 44.2% and 60.1% of its IE Direct Examination Staff Years (DESYS)[11] dedicated to taxpayers not in the Coordinated Examination Program (CEP) for large taxpayers, i.e., non-CEP taxpayers, to the audit of FCCs.[12]

International Exam Resources Dedicated to Non-CEP FCC Exams

Fiscal Year	DESYS in Annual Business Plan Dedicated to non-CEP FCC Exams	% of Total non-CEP DESYS Dedicated to FCC Exams in Annual Business Plan	Actual DESYS Dedicated to non-CEP FCC Exams	% of Actual Total DESYS Dedicated to non-CEP FCC Exams
1995	81	40.6%	119.81	60.1%
1996	81	40.9%	107.82	54.3%
1997	81	45.9%	98.97	46.5%
1998	81	45.6%	87.25	44.2%

As a result of this focus, approximately 54% of all non-CEP returns (including those with no section 482 issue identified) closed during the period covered by this report were non-CEP FCCs. This percentage may be compared to the fact that FCCs generally constitute between 2 and 3% of all corporate income tax returns filed. As noted above, the methodology of this report is based on operational audits. To the extent that section 482 adjustments for FCCs are over represented in the data, the tax gap totals will overstate the proportion of the "true" tax gap that is attributable to FCCs. In addition, to the extent that

[11]Direct Examination Staff Years (DESYS) are hours spent on examinations and do not include training, leave, and administrative time.

[12]The Coordinated Examination Program covers approximately 1,500 of the largest corporate taxpayers. All CEP taxpayers are audited annually.

average noncompliance by FCCs is higher or lower as compared to average compliance by non-FCCs, the overall tax gap will be over or understated as a result of this audit emphasis.

Our tax gap estimates are probably biased upward because we derived them by applying an average marginal corporation tax rate (34%) to income adjustments proposed by examiners. Thus, our estimates do not take into account the fact that tax assessments ultimately agreed to by taxpayers after all appeals and litigation have been completed are, on average, lower than the tax deficiencies proposed by examiners. Generally speaking, the true tax liability may be regarded as likely to lie within the range encompassed by the proposed and assessed liabilities.[13] Also, our estimates do not take into account the fact that if a corporation has current or prior year losses, an audit adjustment that results in an increase in income does not necessarily result in increased tax liability for the current year. In an examination of a deficit return, adjustments to income that do not exceed the reported deficit produce no adjustments to the tax liability. For deficit returns, therefore, the effective tax rate on the total adjustment to income will be lower than the nominal tax rate.

Finally, our analysis of IE examination results for pre- and post-December 31, 1994 taxable years does not correct for a number of factors that may distinguish operational audits conducted during different time periods. For example, the data may be affected by such factors as management emphasis on closing cases more quickly or by a focus on particular issues, industries, or groups of taxpayers during one audit time period as compared to another. These factors are difficult to correct for without conducting audits in a way designed to detect compliance trends over time, or by gathering more extensive data from our operational examination program. These non-taxpayer related factors can mask, and appear to have masked in this study, taxpayer compliance trends and render such analysis inconclusive.

VI. Findings

Appendix A presents our average annual gross section 482 income tax gap estimates for fiscal years 1996-1998. Estimates are provided for both FCCs and

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[13] For a more complete discussion of the advantages and disadvantages of these two types of estimates, see IRS Publication 1415 (4-90), Income Tax Compliance Research: Net Tax Gap and Remittance Gap Estimates, pp. 13-15.

for non-FCCs. Estimates are shown for five industry groups and for small, mid-size, and large corporations.[14]

As shown in Appendix A, the total section 482 income tax gap is estimated to amount to $2.8 billion. This includes a $2.0 billion gap attributable to FCCs and a $0.8 billion gap attributable to U.S. controlled domestic corporations.

The industry group comprising the largest share of the Appendix A section 482 tax gap is manufacturing, accounting for approximately $1.4 billion of estimated tax gap, or about half of the total. Next largest is wholesale and retail trade, accounting for another $0.9 billion. The estimated tax gap attributable to finance, insurance, and real estate is slightly more than $0.2 billion, while services account for less than $0.2 billion of estimated tax gap. The estimated tax gap attributable to all other industries is $0.1 billion. These relative size rankings among industry groups also hold true if one looks at FCCs alone. In the case of non-FCCs, however, the “other industries” group, which accounts for an estimated $0.1 billion of the gap, is more important than finance, insurance, and real estate ($0.09 billion) or the services group ($0.02 billion).

On the whole, large corporations account for the major portion of our estimated total section 482 tax gap—an estimated $1.5 billion. Mid-size corporations account for another $1.0 billion, and small corporations $0.4 billion. In the case of FCCs, however, mid-size corporations account for more of the estimated tax gap ($1.0 billion) than do large corporations ($0.8 billion). In the case non-FCCs, small corporations are a more important component ($0.1 billion) of the gap than are mid-size corporations ($0.05 billion).

In Chapter 2, we describe the significant administrative developments including the contemporaneous recordkeeping requirements under section 6662(e) and the final section 482 regulations published in 1994. Both of these developments are expected to improve compliance. Even though our estimates of the aggregate amount of noncompliance are very uncertain, we compared the available data from certain returns for taxable years ending December 31, 1994 and later with certain returns ending before that date in an effort to determine whether these significant legal changes have changed IE examination results in a way that suggests improved compliance. These results for the selected tax

[14]Small corporations are defined here as those having assets of less than $10 million, mid-size corporations as those having from $10 million to $250 million in assets, and large corporations as those having assets of $250 million or more.

returns are set forth in Appendix B. The overall results are analyzed further for CEP taxpayers and non-CEP taxpayers.

The analysis is inconclusive. For all selected returns, there is some reduction in the average proposed adjustment per return between the 1992 and 1993 tax grouping and the 1994 and 1995 tax grouping ($1,654,902 vs. $826,294); on its face, this appears to indicate improved compliance. However, this change is not statistically significant, and, therefore, no conclusions concerning compliance may be drawn. Perhaps more importantly, the average proposed adjustment <u>increased</u> between these periods for CEP taxpayers (from $3,133,119 to $3,794,829) where the legal changes would be expected to have the greatest effect; this change is not statistically significant. The comparability of these examinations is doubtful given the noticeably smaller number of CEP cases that closed in the earlier period compared to the number closed in the later period (51 vs. 100). There is a statistically significant reduction in the average proposed adjustment between the periods for non-CEP taxpayers. However, the dramatic change in the number of returns closed during the two periods, (151 vs. 602) suggests that other factors could account for the decrease (from $1,155,636 to $333,182). For example, IRS has been working with taxpayers in recent years to bring audit cycles more current. This may account for the large increase in tax return closures for both CEP and non-CEP taxpayers and render simple comparisons of average adjustments between the two periods unproductive.

From this analysis, it is clear that the available data will not support any conclusion about the impact on compliance of the major legal changes that took effect for the 1994 taxable year. Given the significant number of returns in this analysis and the apparent presence of factors unrelated to the legal changes, i.e., reduced elapsed time of IE examinations, that are affecting the data, it is possible that accumulation of additional data as more post-1993 cases close will not provide a definitive answer as to whether the section 6662(e) penalties and the 1994 final section 482 regulations have affected examination results.

CHAPTER 2: LEGAL AND ADMINISTRATIVE DEVELOPMENTS

I. Introduction

A. Issues In Brief

Section 482 authorizes the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers in order to prevent evasion of taxes or clearly to reflect their income. Application of section 482 to multinational operations may involve a wide range of technical and factual issues. For example, if a domestic distribution subsidiary buys goods from its foreign parent for resale to unrelated parties, what markup should it earn? Or, if an offshore subsidiary uses patents and manufacturing know-how belonging to its U.S. parent, what rate of royalty should the parent earn for permitting the subsidiary to use its intangible assets? In general terms, section 482 asks whether prices charged by one affiliate to another in an intercompany transaction involving the transfer of goods, services, or intangibles yield results for the transaction that are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. This standard of a taxpayer dealing at arm's length with an uncontrolled taxpayer, known as the arm's length standard, has been incorporated in regulations under section 482 or its predecessors for over 60 years.

The IRS's goal in administering section 482 is to ensure that each controlled taxpayer reflects its true taxable income from intercompany transactions as determined under the arm's length standard. For example, if the IRS determines that a foreign related party overcharged its U.S. affiliate for goods or services, IRS may adjust the transfer price downward, thereby increasing the U.S. party's taxable income. If the foreign country in question agrees that the transfer prices were too high, it may agree to make a correlative adjustment decreasing the income of the foreign affiliate. However, if the foreign country disputes the validity of the adjustment, and declines to make a correlative adjustment, some portion of the income will be subject to double taxation, once in the foreign country and once in the United States. The common adoption of the arm's length principle in all 50 of our current income tax treaties (with the one exception of that with the former U.S.S.R.) and in the guidelines of the Organization for Economic Cooperation and Development (OECD) minimizes the potential for double taxation and provides a basis to resolve double tax cases by mutual agreement under the treaties.

B. History of Section 482

As early as 1917, the IRS was authorized to allocate income and deductions among affiliated corporations, and to require affiliated corporations to file consolidated returns. The predecessors of current section 482 date to 1921 and 1928. The provision added as section 45 of the 1928 Internal Revenue Act authorized the Commissioner to make adjustments to accounts of related parties to the extent necessary to prevent tax avoidance and to ensure the clear reflection of income. The legislative history clarified that the latter authority permitted the Commissioner to determine the "true taxable income" of related parties. H.R. Rep. No. 2, 70th Cong., 1st Sess. 16-17 (1928).

Since 1935, the regulations (then under section 45) have utilized the "arm's length" standard as the means to effectuate the provision. Transfer pricing regulations issued in 1968 provided further guidance on the application of the arm's length standard, including specified pricing methods and additional rules for particular types of intercompany transactions.

In 1986, Congress added a second sentence to section 482 which required related party transfers of intangible property to yield income "commensurate with the income attributable to the intangible." In addition to a basic concern that high-profit intangibles were being transferred outside the U.S. tax jurisdiction without adequate consideration, the legislative history of this provision reflected dissatisfaction with the comparability analysis in some judicial decisions:

> Certain judicial interpretations of section 482 have suggested that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a 'safe harbor' for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. See, e.g., United States Steel Corporation v. Commissioner, 617 F.2d 942

> (2d Cir. 1980). While Congress was concerned that such decisions may unduly emphasize the concept of comparables even in situations involving highly standardized commodities or services, it believed that such an approach is sufficiently troublesome where transfers of intangibles are concerned that a statutory modification to the intercompany pricing rules regarding transfers of intangibles was necessary.

Staff of Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, 100th Cong., 1st Sess. 1014-15 (1987).

In 1990, Congress in section 6662(a), (e), and (h)(2)(A) enacted 20% and 40% accuracy-related penalties for substantial and gross valuation misstatements. In 1993 these provisions were amended to specifically focus on whether the taxpayer generates contemporaneous documentation and analysis of its transfer pricing decisions, and provides such documentation promptly in response to a request from the IRS.

After the White Paper (A Study of Intercompany Pricing Under Section 482 of the Code, 1988-2 C.B. 458) in 1988, proposed regulations in 1992, and temporary regulations in 1993, the IRS issued final regulations under section 482 in July 1994. The IRS also issued temporary regulations under section 6662(e) in July 1994 and then final regulations in 1996. These regulations are discussed in Sections II and III below.

The United States has helped build a international consensus in favor of the arm's length standard. All of our 50 current income tax treaties (with the one exception of that with the former U.S.S.R.) contain articles requiring mutual application of the arm's length principle to resolve transfer pricing disputes. The OECD similarly adopted the arm's length principle as the foundation first of its 1979 report (Transfer Pricing and Multinational Enterprises) and then of its 1995 Transfer Pricing Guidelines (Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations). Since 1995, many major U.S. trading partners have amended their domestic laws governing transfer pricing to incorporate the arm's length principle, and put into effect transfer pricing documentation requirements, consistent with the OECD Transfer Pricing Guidelines.

C. Administrative Problems

The significant factors that have hindered effective administration of section 482 in the past are reviewed briefly below.

1. No contemporaneous evaluation of transfer prices

Typically taxpayers did not take the arm's length standard into account for purposes of reporting their taxable income from intercompany transactions. When IRS examiners audited the returns, they generally found that no analysis or documentation existed to explain the appropriateness of transfer prices. Indeed, taxpayers only began their attention to the transfer pricing issue during the audit process, several years after the period in which the transactions took place. With hindsight, taxpayers often had the incentive to adopt positions that arguably supported extreme results.

2. Priority of transfer pricing methods

The 1968 regulations set forth a hierarchy of methods to be used to determine transfer prices. Where the taxpayer or the IRS argued for application of a lower priority method, the hierarchy in effect created a threshold burden to disprove the applicability of the higher priority method or methods not selected.

3. Limited access to necessary information

International examiners (IEs) who conducted audits of multinational enterprises often needed access to company records that were located outside the United States. Inability to obtain such information, or long delays between the original request and the receipt of information, were prevalent in the case of foreign-owned groups. These problems were especially difficult in the case of entities located in tax haven countries with which the United States had no provision for sharing of tax related information. In some cases, delays on the part of the taxpayer in providing information required IEs to close transfer pricing audits with no adjustment. Where the cases went forward, the difficulty in obtaining relevant information from the taxpayer significantly contributed to the long delays in resolving these matters.

4. Protracted disputes

When the IRS made adjustments under section 482, the positions of the IRS and the taxpayer were generally far apart, both in terms of pricing methodology and dollar amount of the adjustment. In the absence of any contemporaneous documentation, the development of the facts necessary to the fact-intensive evaluation under the arm's length standard effectively began only years after the fact. The taxpayer enjoyed the advantage of starting with a better command of the facts relevant to its business. Matters not resolved by Appeals went on to become matters on the docket of the Tax Court, as the magnitude of the section 482 adjustments and the resulting deficiencies in tax generally prevented taxpayers from paying the tax first and seeking refunds in District or Claims Court. At the litigation stage, polarized positions and taxpayer delays in furnishing information to IRS further contributed to contentious and protracted disputes. See discussion of tax litigation in Chapter 7.

D. Five-Part Strategy to Improve Administration of Section 482

Since the April 1992 report, the IRS has followed a five-part strategy to improve the administration of section 482. The overall aim has been to shift the focus from after-the-fact audit and litigation of transfer pricing controversies to encouragement of upfront taxpayer compliance and advance resolution of transfer pricing issues.

- First, the IRS has promulgated guidance on the application of the arm's length standard. Principal in this category are the final section 482 transfer pricing regulations issued in 1994.

- Second, the IRS, with the strong backing of Congress, has moved to ensure that taxpayers apply the arm's length standard as provided for in the transfer pricing regulations at the time they file their original return and that taxpayers have contemporaneous documentation establishing such compliance.
    - This contemporaneous documentation is provided for in section 6662(e), as amended in 1993. The IRS issued temporary regulations in 1994 and final regulations in 1996 implementing this provision.
    - The incentive for taxpayers to undertake these compliance responsibilities are the penalties that are otherwise applicable under section 6662(a) and (h) in the event a taxpayer's transfer pricing is adjusted by the IRS.

- Third, the Treasury and the IRS have worked to build a worldwide consensus on the application of the arm's length principle to particular facts and the taxpayer's responsibility to contemporaneously document compliance. The OECD reflected that consensus in guidance on the arm's length principle and taxpayer responsibility in its 1995 Transfer Pricing Guidelines. Major U.S. trading partners have subsequently adopted legislation and other guidance implementing the approach taken by the 1995 OECD Guidelines. The international consensus on the arm's length principle is the basis for resolution of double tax cases in the competent authority process under income tax treaties discussed in Chapter 5.

- Fourth, the IRS has encouraged taxpayers to use the Advance Pricing Agreement (APA) program to provide certainty and advanced resolution of potential transfer pricing disputes. An APA may protect both against section 482 adjustments and section 6662(e) penalties. The APA program is discussed in Chapter 6 of this report.

- Fifth, Chief Counsel has developed procedures to coordinate the necessary technical and litigation support in litigation involving cross-border transactions.

E. Other Important Compliance Provisions

In addition to sections 482 and 6662(e), there are other important provisions that are relevant to transfer pricing cases:

1. Sections 6038A and 6038C

Section 6038A imposes reporting, recordkeeping, and document production obligations, and provides the IRS with summons authority with respect to the related party transactions of foreign-based groups and their 25% or greater U.S. affiliates. Section 6038C imposes similar requirements on foreign corporations engaged in a trade or business in the United States without regard to the percentage of foreign ownership. There are penalties for noncompliance. Congress amended section 6038A, and enacted section 6038C, in response to the above-described problems IRS experienced in obtaining foreign-based information relevant to transfer pricing determinations.

2. Section 982

Section 982 authorizes the IRS to issue to taxpayers formal document requests for foreign-based documentation. If the taxpayer fails to comply with a formal document request without reasonable cause, this provision bars the taxpayer from subsequently introducing the documentation in subsequent civil tax litigation.

3. Section 6501(c)(8)

Section 6501(c)(8) extends the statute of limitations for three years after the date on which the IRS obtains information required to be reported under section 6038, 6038A, 6038B, 6046, 6046A, or 6048. This provision serves as a backup to Forms 5471 and 5472, which inform the IRS of relevant related party transactions that may require examination for compliance with the arm's length standard.

4. Section 6503(j)

Section 6503(j), formerly section 6503(k), authorizes the IRS to issue a single designated summons per income tax return. This designated summons prevents expiration of the statute of limitations pending judicial enforcement of the summons, as well as any related summonses issued within 30 days of the original summons.

5. Section 1059A

Section 1059A caps the section 482 cost of certain dutiable imported merchandise at the amount taken into account in computing customs value for duty purposes. The purpose is to prevent a potential whipsaw which would result if affiliated taxpayers in inbound transactions could claim one value for customs purposes, while reporting higher transfer prices on the same items in computing taxable income.

II. Guidance on Application of Arm's Length Standard

This section summarizes the substantive guidance issued since the 1992 report on the application of the arm's length standard.

A. Section 482 Transfer Pricing Regulations

The central guidance for taxpayers and IRS examiners on the application of the arm's length standard is set forth in the final regulations under section 482 issued in July 1994. T. D. 8552, 1994-2 C.B. 93.[15] These regulations were developed at the same time as, and are fully consistent with, the 1995 OECD Transfer Pricing Guidelines. The salient provisions of the regulations are discussed below.

1. Functional analysis and comparability

Fundamentally the arm's length standard calls for an evaluation of the functions performed, assets used, and risks assumed by commonly controlled taxpayers in their intercompany transactions as measured against those elements of "comparable" uncontrolled transactions entered into by uncontrolled taxpayers. The regulations elaborate upon the factors for determining comparability, including the functions, contractual terms, risks, economic conditions, and nature of the property or services involved in the controlled and uncontrolled transactions. In addition to the general guidance on comparability, guidance is also provided on the significant comparability considerations under particular transfer pricing methods.

The regulations flexibly recognize that comparability need not be exact, but

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[15]The final regulations had been preceded by temporary and proposed regulations issued in January 1993. T.D. 8470, 1993-1 C.B. 90.

the uncontrolled transaction either must be, or must be adjusted to be, sufficiently similar to provide a reliable measure of an arm's length result. Generally, adjustments based on commercial practices, economic principles, or statistical analyses must be made for material differences between the controlled and uncontrolled transactions, if the reliability of the measure is improved. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis is reduced. The extent and reliability of any adjustments affects the relative reliability of the analysis under the best method rule.

2. Best method rule

Under the regulations, the arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Neither the IRS nor the taxpayer is held to the former hierarchy of methods, but if another method is subsequently shown to produce a more reliable measure of an arm's length result, such other method prevails.

In the selection of the best method, the two primary factors to take into account are the degree of comparability between the controlled and uncontrolled transactions and the quality of the data and assumptions used in the analysis. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method.

3. Range of arm's length results

The regulations recognize that generally there will not merely be a single, but a range of possible arm's length results of a controlled transaction (arm's length range). The results reported by the taxpayer for a controlled transaction will not be subject to an IRS adjustment if the results fall within the arm's length range.

The arm's length range is derived only from those uncontrolled transactions that have, or through adjustments can be brought to, a similar level of comparability and reliability. Those uncontrolled comparables that have a significantly lower level of comparability and reliability may not be used in establishing the arm's length range.

The regulations provide rules for defining the range, including rules for increasing the reliability of the analysis where inexact comparables are used. The regulations also provide rules for the IRS adjustments that may be made where the results of a controlled transaction fall outside the arm's length range.

4. Transfers of tangible property

Subject to the best method rule, the regulations permit the arm's length results of controlled transactions involving the transfer of tangible property, e.g., the intercompany sale of goods, to be determined under any of five specified methods or under an unspecified method. The five specified methods are the comparable uncontrolled price (CUP) method, the resale price method, the cost plus method, the comparable profits method, and the profit split method.

Under the CUP method, the transfer price in a controlled transfer of tangible property is evaluated by reference to the price in a comparable uncontrolled transaction. The regulations provide guidance on the comparability considerations and adjustments (e.g., for volume, level of the market, geographic market, or trademark). In particular, similarity of products generally will have the greatest effect on comparability under this method. The results derived from the CUP method generally will be the most direct and reliable measure of an arm's length result, if either there are no differences between the controlled and uncontrolled transactions, or there are only minor differences with definite and reasonably ascertainable effects on price for which appropriate adjustments are made. If such an exact comparable is not available, the CUP method may still be used based on an inexact comparable, but the reliability of the analysis as a measure of arm's length results will be reduced.

The resale price method evaluates the gross profit margin earned in the controlled transaction by reference to the gross profit margin realized in comparable uncontrolled transactions. The regulations provide guidance on comparability considerations and adjustments, including on the need for consistency as between the controlled and uncontrolled transactions in cost accounting practices that materially affect the gross profit margin. The resale price method focuses on the value of the reselling functions, so while similarity in functions, risks, and contractual terms is significant, comparability under this method is less dependent on similarity in the physical products being distributed. The resale price method is not ordinarily used where the controlled taxpayer uses its intangible property, e.g., trademarks, to add substantial value to the goods resold.

The cost plus method evaluates the gross profit markup earned in the controlled transaction by reference to the gross profit markup realized in comparable uncontrolled transactions. The regulations provide guidance on comparability considerations and adjustments, including on the need for consistency as between the controlled and uncontrolled transactions in cost accounting practices that materially affect the gross profit markup. The cost plus method focuses on the value of the production functions, so while similarity in functions, risks, and contractual terms is significant, comparability under this method is less dependent on similarity in the physical products being produced.

The comparable profits method evaluates the operating profit earned in the controlled transactions (relevant business activity) by reference to the operating profit that would have been earned if performance in the relevant business activity were equal to the profit level indicator in comparable uncontrolled transactions. The relevant business activity encompasses the most narrowly identifiable business activity for which data incorporating the results of the controlled transactions is available. In this analysis, the tested party, i.e., the controlled taxpayer whose relevant business activity is being evaluated, generally is the least complex the affiliated taxpayers and does not utilize valuable intangible property or unique assets in the controlled transactions to a degree that is distinguishable from the uncontrolled transactions. The regulations provide for a variety of profit level indicators, such as the ratios of operating profit to operating assets, operating profit to sales, and gross profit to operating expenses. Generally, the analysis must be made over at least a three-year period comprising the taxable year under review and the preceding two taxable years, since use of data from multiple years may increase reliability by avoiding the distorting effects on operating profit of business cycles or life cycles of the product or intangible being examined. The regulations provide guidance on comparability considerations and adjustments, including on the need for consistency as between the controlled and uncontrolled transactions in cost accounting practices that materially affect operating profit, and on the need to allocate costs, income, and assets between the relevant business activity and other activities of the tested party and the uncontrolled comparable. The comparable profit method focuses on the return on investment of resources and assumption of risk in the relevant business activity, so similarity in resources employed and risks assumed is significant. Comparability under this method is less dependent on similarity in physical products and, moreover, generally tolerates a greater degree of functional differences than other methods since taxpayers performing different functions may have very different gross profit margins, but earn similar levels of operating profit. On the other hand, comparability under this method may be more sensitive to other factors, e.g., management efficiency, that may affect the reliability of the analysis.

The profit split method is applied using one of two alternative approaches. Under the comparable profit split, the combined operating profit or loss earned by the controlled taxpayers in the controlled transactions (relevant business activity) is allocated between them by reference to the allocation between uncontrolled taxpayers of the combined operating profit or loss in comparable uncontrolled transactions. Under the residual profit split, a two step process is used to allocate the combined operating profit or loss from the relevant business activity between the controlled taxpayers. The first step allocates operating income to each party to provide a market return to its routine contributions of tangible property, services, and intangibles to the relevant business activity. Such market returns may be determined under any of the other provisions of the regulations (e.g., the comparable profits method). The second step allocates the residual profit or loss between the parties based on the relative value of their contributions of unique intangible property to the relevant business activity, as measured by external or internal gauges. The regulations provide guidance on comparability considerations and adjustments, including on the need for consistency as between the controlled and uncontrolled transactions in cost accounting practices that materially affect operating profit, and on the need to allocate costs, income, and assets between the relevant business activity and other activities of the parties. The reliability of the analysis under the comparable profit split and the first step of the residual profit split depends on similar considerations as apply for the external market benchmarks used under other provisions of the regulations. To the extent the allocation of profit or loss in the second step of the residual profit split is not based on external market benchmarks, the reliability of the analysis is decreased. The reliability of both profit split approaches may be enhanced by their two-sided evaluation of the contributions of both parties to the controlled transactions, as distinguished from the one-sided analysis under other methods, provided data and assumptions with respect to both parties are similarly reliable.

The regulations also permit the use of unspecified methods, subject to the best method rule. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the realistic commercial or business alternatives prior to entering into a transaction. Thus, an unspecified method should provide information on the prices or returns available under realistic alternatives to the controlled transaction.[16]

5. <u>Transfer of intangible property</u>

Subject to the best method rule, the regulations permit the arm’s length results of controlled transactions involving the transfer of intangible property, e.g., the intercompany license of patents, to be determined under any of three specified methods or under an unspecified method. The three specified methods are the comparable uncontrolled transaction (CUT) method, the comparable profits method, and the profit split method. The comparable profits, profit split, and unspecified methods are discussed above.

[16] The 1994 final regulations deleted the procedural provision, which had been contained in the 1993 temporary regulations, requiring disclosure on the tax return of the use of an unspecified transfer pricing methodology.

Under the CUT method, the transfer price in a controlled transfer of intangible property is evaluated by reference to the price in a comparable uncontrolled transaction. The regulations provide guidance on the comparability considerations and adjustments (e.g., exclusive or nonexclusive rights, stage of development of the intangible, and duration of license). In particular, application of this method requires that the controlled and uncontrolled transactions involve either the same or comparable intangible property. To be comparable for this purpose, both intangibles must be used in connection with similar products or processes within the same general industry or market and have similar profit potential. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. The results derived from the CUT method generally will be the most direct and reliable measure of an arm's length result, if either there are at most only minor differences between the controlled and uncontrolled transactions with definite and reasonably ascertainable effects on price for which appropriate adjustments are made. If such an exact comparable is not available, the CUT method may still be used based on an inexact comparable, but the reliability of the analysis as a measure of arm's length results will be reduced.

The regulations implement the commensurate with income principle of the second sentence of section 482 with respect to transfer of intangible property. The regulations authorize the IRS to adjust the consideration charged for the transfer in subsequent years, even if the charges in earlier years are determined to be arm's length (periodic adjustments). The regulations provide for exceptions to the periodic adjustments rule. Among the exceptions are cases in which the consideration charged for the transfer is based on an exact comparable or, where an inexact comparable is used, the actual results do not diverge (except due to extraordinary events beyond the taxpayer's control that could not reasonably have been anticipated) from projected results by more than 20% (among other conditions).

6. Loans, services, and leases

The regulations continue provisions from the 1968 regulations governing application of the arm's length standard to intercompany loans, services, and leases.

7. Inexact comparables

The regulations authorize the use of inexact comparables under all transfer pricing methods. Use of such comparables is subject to an evaluation of the relative reliability of their results under the best method rule. Use of inexact comparables may also require adjustment of the arm's length range as a means of increasing reliability.

B. Section 482 Cost Sharing Regulations

In 1996, the IRS issued final regulations relating to qualified cost sharing arrangements under section 482. T.D. 8632, 1996-1 C.B. 85, as amended by T.D. 8670, 1996-1 C.B. 99.

In enacting the commensurate with income principle with respect to the transfer of intangible property, Congress indicated that it did not intend to curtail the use of bona fide research and development agreements by related parties. H.R. Rep. No. 281, 99th Cong., 2d Sess. at II-638 (1986). The cost sharing regulations set forth the rules under which affiliates may share ownership of intangibles by sharing the development costs, thereby obviating the need to apply the transfer of intangible property rules to determine an arm's length royalty.

A cost sharing arrangement is defined as an agreement to share the costs of development of one or more intangibles in proportion to the shares of reasonably anticipated benefits from the parties' individual exploitation of their assigned interests in the intangibles. A taxpayer must also satisfy formal requirements in order to claim the treatment provided under the regulations for a qualified cost sharing arrangement. In particular, there must be contemporaneous documentation of the arrangement, the methodology, the research to be undertaken, and each participant's interest in any intangible property that is developed. The IRS may apply the treatment under the regulations to what in substance constitutes a cost sharing arrangement, notwithstanding a failure to meet a formal requirement for a qualified cost sharing arrangement. The regulations clarify that a cost sharing arrangement will not be treated as a partnership, and will not of itself cause effectively connected trade or business (or permanent establishment) status for a foreign participant.

IRS adjustments with regard to a qualified cost sharing arrangement are limited to bringing cost shares into equivalence with benefits shares. However, if a controlled taxpayer acquires an interest in intangible property from another controlled taxpayer (other than in consideration for bearing a share of the costs of the intangible's development), then the IRS may make adjustments under the general rules governing transfers of intangible property.

The participation rules generally require that a participant in a qualified cost sharing arrangement must reasonably anticipate benefits from the use of intangibles that are developed as the result of research undertaken pursuant to the arrangement (covered intangibles). In addition, to qualify for participation certain formal requirements must be satisfied related to accounting, documentation, and reporting.

The regulations flexibly permit the taxpayer to define the scope of research and development to be covered (intangible development area). Thus, the intangible development area includes research and development actually undertaken under the cost sharing arrangement. Covered intangibles include any intangible that actually results from the research and development under the cost sharing arrangement.

The intangible development costs to be shared under a cost sharing arrangement include all costs related to the intangible development area (i.e., operating expenses, other than depreciation or amortization, plus a charge for the use of tangible property), plus cost sharing payments made, and minus cost sharing payments received. Separate consideration (the buy-in) is required for pre-existing intangible property made available to the arrangement, as determined under the general rules governing transfer of intangible property.

Whether a controlled participant is bearing an appropriate cost share is determined by comparing its share of the total intangible costs of all controlled participants to its share of the total reasonably anticipated benefits of all controlled participants. For this purpose, anticipated benefits are the additional income generated or the costs saved by the use of covered intangibles. A controlled participant’s share of reasonably anticipated benefits must be determined using the most reliable estimate of reasonably anticipated benefits.

The reliability of a benefits estimate depends in particular on the reliability of the basis used for measuring benefits and the reliability of projections used to estimate benefits. Measures of benefits can be direct (i.e., of additional income to be generated or costs saved from the use of covered intangibles) or indirect. Indirect measures may include units used, produced or sold, sales, operating profit, or other bases, to the extent that there is expected to be a reasonably identifiable relationship between the basis used and benefits attributable to the use of covered intangibles. The regulations indicate which indirect measure is likely to be most reliable under given circumstances.

Projections whose reliability must be evaluated include projections of the time period before benefits are to be received, the time period over which benefits will be received, and the benefits anticipated for each year. Current benefit shares may be the most reliable projection of anticipated benefit shares if the arrangement is a long-term arrangement, if it covers a wide variety of intangibles, if the composition of intangibles is unlikely to change, if the intangibles are unlikely to generate unusual profits, and if each participant's share of the market is stable. A significant divergence between projected and actual benefit shares may indicate that the projections were not reliable, but a divergence of 20% or less for every controlled participant will not be considered unreliable, and IRS will not make an allocation based on a divergence that is due to an extraordinary event beyond the taxpayers' control and reasonable anticipation.

The general rules for transfer of intangible property will continue to govern new entry, exit, and other changes in interest among the participants in a cost sharing arrangement. Moreover, if, after any cost allocations, a controlled participant bears costs that over a period of years are consistently and materially greater or lesser than its share of reasonably anticipated benefits, IRS may allocate income under the general rules consistent with the course of conduct.

C. Guidance for Specialized Industries and New Technologies

1. Proposed regulations on global dealing

In 1998, the IRS issued proposed regulations which addressed the allocation and sourcing of income from a global dealing operation. 63 Fed. Reg. 11,177 (March 6, 1998).[17] Global dealing refers to execution by financial institutions of customer transactions in a financial product or line of financial products, in multiple tax jurisdictions and/or through multiple participants.

There are three main parts of the proposed regulations. The first part adapts the general guidance under the section 482 regulations to the particular context of a global dealing operation in which two or more affiliates participate. The regulations provide guidance on the conditions and comparability considerations for application of four specified methods (comparable uncontrolled financial transaction method, gross margin method, gross markup method, and profit split method) and unspecified methods. The regulations take into account comparability factors unique to the financial services industry and are designed generally to accommodate the range of business structures that are utilized in global dealing

[17] At the same time as the proposed regulations were being developed, the Treasury and the IRS had been actively participating in the work of the OECD in this area. OECD, The Taxation of Global Trading of Financial Instruments (1998) (updated discussion draft revising earlier version of February 14, 1997). In addition, the U.K. Inland Revenue recently issued relevant guidance. U.K. Inland Revenue, Tax Bulletin, paragraphs 61-62 (December 1998).

operations by adopting the “best method” rule for selection of the correct transfer pricing method for each global dealing activity.

The second part of the proposed regulations provides guidance on the sourcing of the income from a global dealing operation conducted in multiple locations by a single taxpayer. The proposed regulations generally adopt the approach that sources an amount of income to each location as would have been allocated to that location under the special section 482 guidance if the various locations were separate affiliates participating in the global dealing operation. The regulations take into account, however, the economic differences between acting through a single legal entity and through separate legal entities. In particular, the regulations effectively provide that compensation for risk bearing should be sourced by reference to where capital of the entire entity is employed in the global dealing operation by traders, marketers and salespeople, rather than by reference to the residence of the capital provider.

The third part of the proposed regulations provides guidance on coordination of the different timing rules, based on mark-to-market accounting, applicable to the global dealing “desk” within a single financial services entity, as distinguished from its lending or other desks.

These regulations recognize that risk may be transferred among separate operating units of an affiliated group or multiple locations of a single taxpayer, and that the transfer can be respected for tax purposes by virtue of the separately identifiable accounting treatment and risk management activities performed by the respective units in the ordinary course of their business.

Although the regulations provide transfer pricing guidance with respect to related party transactions entered into by a global dealing operation, the proposed rules are limited to transactions in securities and foreign currency. The regulations do not extend to transactions in commodities or to proprietary trading operations that include related-party transactions in securities.

2. Electronic commerce

Treasury and the IRS have been studying the implications of the internet and related technologies for income tax administration including section 482 issues.[18] Conceptually, electronic commerce does not present any different transfer pricing issues than for more longstanding modes of doing business. The task remains to evaluate the arm’s length results of functions performed, resources employed, and

[18] See Selected Tax Policy Implications of Electronic Commerce (November 1996); A Framework for Global Electronic Commerce (July 1997).

risks assumed in domestic and foreign tax jurisdictions, and to minimize any potential for double taxation. The Treasury and IRS are actively involved in the OECD consideration of these issues.[19]

D. Conforming Accounts to Reflect Section 482 Adjustments

The process for conforming the accounts of affiliates to reflect primary section 482 adjustments by the IRS is currently set forth in Rev. Proc. 65-17, 1965-1 C.B. 833.[20] Consider, for example, the case of a U.S. parent that undercharges its foreign subsidiary in an intercompany transaction. If the IRS makes a primary adjustment increasing the income of the parent, there is a need to conform the accounts of the parent and subsidiary to reflect that the subsidiary did not actually pay the parent the additional cash necessary to make up for the undercharge. Without more, the conforming adjustment would be to reflect the additional amount as a capital contribution to the subsidiary. Rev. Proc. 65-17 sets forth procedures by which taxpayers may adopt either of two alternative means to conform their accounts. Under one alternative, taxpayers may offset the primary adjustment to the extent of the amount of a dividend paid in the same year (dividend offset).[21]

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[19] From October 7 to 9, 1998, the United States joined with other OECD member states in a ministerial level conference in Ottawa regarding taxation of electronic commerce in the global marketplace, entitled: "A Borderless World: Realizing the Potential of Global Electronic Commerce." In a declaration at the end of the conference, the ministers recognized certain common principles regarding electronic commerce, including agreement in principle that no taxes specific to internet commerce should be enacted. Working groups were established to carry forward the consideration of taxation issues related to electronic commerce. See OECD, Electronic Commerce: Taxation Framework Conditions.

[20] See also Rev. Rul. 82-80, 1982-1 C.B. 89, extending Rev. 65-17 to inbound cases.

[21] See also Rev. Proc. 70-23, 1970-2 C.B. 505 and Rev. Proc. 71-35, 1971-2 C.B.

Under the other alternative, taxpayers may set up interest bearing accounts payable and receivable in the amount of the primary adjustment, pay the accounts, and take into income the interest for the period beginning with the end of the year of the primary adjustment up through the date of payment.

The IRS has proposed revisions to Rev. Proc. 65-17 in Announcement 99-1, 1999-2 I.R.B. 41. Four main changes are proposed. While availability of the alternative treatments under Rev. Proc. 65-17 is premised on absence of a tax avoidance motive, under the proposed Revenue Procedure alternative treatment would be available provided that the taxpayer is not subject to a penalty under section 6662(e)(1)(B) or (h) by reason of the primary section 482 adjustment. Dividend offset treatment would be eliminated, so that the only alternative treatment would be the establishment of interest bearing accounts payable and receivable. A procedure is proposed by which taxpayers could establish cash repatriation accounts themselves in situations in which they make taxpayer-initiated primary adjustments (i.e., in connection with their own upfront compliance with the arm's length standard). In addition, the proposed revenue procedure would clarify that, generally, a foreign tax credit is available for foreign withholding tax with respect to the repayment of the principal or interest on a cash repatriation account, subject to the limitations under the foreign tax credit rules.

E. Potential Application of Section 482 to Lease Stripping Abuse

Lease stripping refers generally to a class of transactions in which the parties (which may or may not have overlapping ownership) apportion income from an asset to one party (exempt from the U.S.'s taxing jurisdiction), and deductions associated with the asset to another party (which is subject to the U.S.'s taxing jurisdiction). In Notice 95-53, 1995-2 C.B. 334, the IRS stated that section 482 was one of several Code provisions which might be used to combat abuse in this area, because the participants acted pursuant to a common design to shift income and deductions arbitrarily in an effort to distort the taxable income of one of the parties (i.e., the entity subject to the U.S.'s taxing jurisdiction) . Under the authority of section 482, the Commissioner might reallocate expenses or deductions to a specific party in accordance with the economic substance of the transaction in order to prevent tax evasion or obtain a clear reflection of income.

III. Guidance on Upfront Compliance with the Arm's Length Standard

A. Statutory Framework

The Revenue Reconciliation Act of 1990 amended section 6662 to make the

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573, clarifying the application of the dividend offset in various situations.

penalty applicable to substantial and gross valuation misstatements, and specifically, through subsections (e)(1)(B), (e)(3), and (h)(2)(A), to section 482 adjustments. The penalty is 20% of the portion of any underpayment of tax attributable to a substantial valuation misstatement and 40% of any underpayment of tax attributable to a gross valuation misstatement.

Prior to the 1993 amendment below, a substantial valuation misstatement resulted by reason of a net section 482 transfer price adjustment exceeding $10 million, and a gross valuation misstatement resulted by reason of a net section 482 transfer price adjustment exceeding $20 million (net adjustment penalty). For purposes of determining whether the thresholds for application of the net adjustment penalty were met, there was excluded any portion of what would otherwise have been the net section 482 transfer pricing adjustment to the extent the taxpayer were shown to have had reasonable cause for its determination and the taxpayer acted in good faith. In addition, a substantial valuation misstatement resulted by reason of a transfer price claimed on the taxpayer's return being 200% or more (or 50% or less) than the amount determined under section 482, and a gross valuation misstatement resulted by reason of a transfer price claimed on the taxpayer's return being 400% or more (or 25% or less) than the amount determined under section 482 (transactional penalty). No penalty is imposed with respect to a portion of an underpayment to the extent it may be shown that the taxpayer had reasonable cause for such portion and acted in good faith.

The Revenue Reconciliation Act of 1993 amended the penalty provisions applicable to section 482 adjustments. The 1993 amendment reduced the net adjustment penalty threshold for a substantial valuation misstatement from $10 million to the lesser of $5 million or 10% of gross receipts, and for a gross valuation misstatement from $20 million to the lesser of $20 million or 20% of gross receipts. The transactional penalty thresholds were not changed.

Importantly, in lieu of the threshold consideration of reasonable cause and good faith of the taxpayer, the 1993 amendment made the net adjustment penalty applicable only where the taxpayer has failed to undertake an upfront effort to comply with the arm's length standard, to contemporaneously document that compliance, and to provide that documentation to the IRS within 30 days of request.[22]

B. <u>Section 6662(e) and (h) Regulations</u>

[22] The regulations similarly provide an excuse from the imposition of the transactional penalty where the taxpayer undertakes these compliance obligations.

The IRS issued final regulations under section 6662(e) and (h) in 1996.[23] The purpose of the guidance had been stated in the preamble to the temporary regulations that the IRS had previously issued in 1994:

[23] T.D. 8656, 1996-1 C.B. 329. Proposed regulations construing the statute prior to the 1993 amendment had been issued in January 1993. 58 Fed. Reg. 5304. Temporary regulations implementing the 1993 amendment had been issued in February and July 1994. T.D. 8519, 1994-1 C.B. 298; 59 Fed. Reg. 35030.

> The experience of the IRS has been that the majority of taxpayers do not provide an explanation of how their intercompany pricing was established. In many cases examiners' access to a corporation's transfer pricing information is delayed or denied. Moreover, many taxpayers do not rely upon any form of comparables or contemporaneous information either in planning or in defending intercompany transactions. . . . The failure by taxpayers to analyze their intercompany pricing prior to audit increases controversy between taxpayers and the IRS, as both seek to develop post hoc analyses of the arm's length character of the transactions. Thus, the failure to apply the arm's length standard in setting prices for controlled transactions (and the lack of contemporaneous documentation explaining that application) increases the time spent and expense incurred by both the taxpayer and the IRS in determining whether that result was consistent with the arm's length standard. Accordingly, these regulations are designed to encourage taxpayers to make a serious effort to comply with the arm's length standard, report an arm's length result on their income tax return, document their transfer pricing analyses, and provide that documentation to the IRS upon request.[24]

The regulations provide guidance on how taxpayers may satisfy their compliance obligations regarding analysis, documentation, and production, and so avoid imposition of the section 482 related penalties. The required compliance depends on whether the taxpayer applies a specified or an unspecified method under the section 482 regulations.

For specified methods, the taxpayer must select and apply a specified method in a reasonable manner. The taxpayer must reasonably conclude that under the facts and circumstances the method and its application provide the most reliable measure of an arm's length result pursuant to the best method rule. For purposes of this analysis, the taxpayer must perform a reasonably thorough search for relevant data and evaluate the potential applicability of the other specified methods.

The taxpayer must maintain documentation of its compliance. The regulations divide the required documentation into two categories, principal documents and background documents. Principal documents (as further subdivided into ten parts) include the basic documentation explaining the business, organization, application of the section 482 regulations, additional relevant data obtained after the end of the tax year prior to filing the tax return, and a general index of the principal and background documents along with a description of the

[24] T.D. 8519, 1994-1 C.B. at 299.

system of cataloguing and accessing these documents. Background documents generally include the relevant backup for the principal documents. All the principal and background documentation must be in existence when the return is filed, with the exception of the summary of post-year end relevant data and the general index and recordkeeping system description.

The taxpayer must provide the documentation to the IRS within 30 days of a request. The IRS may excuse a minor or inadvertent failure to produce documentation, if the taxpayer made a good faith effort to comply and promptly remedies the failure. Background documents need not be produced in response to a request for principal documents, and the IRS may, in its discretion, extend the period for producing background documentation.

For unspecified methods, the taxpayer must reasonably conclude that under the facts and circumstances none of the specified methods was likely to provide a reliable measure of an arm's length result, and that the method selected is applied in a way that would likely provide a reliable measure of an arm's length result. For purposes of this analysis, the taxpayer must evaluate the potential applicability of the specified methods in light of the best method rule. If the intercompany transaction being analyzed is of a type for which no methods are specified under the section 482 regulations, the taxpayer must conclude that the method and its application provide the most reliable measure of an arm's length result under the best method rule. The documentation and production requirements are essentially the same for unspecified methods as for specified methods.

The requirements to contemporaneously document compliance with the arm's length standard, and promptly provide that documentation to the IRS upon request, play an important role in ameliorating problems previously experienced in the administration of section 482. Shortly after an examination begins, the IRS will now have available documentation (and an index) with respect to the taxpayer's products or services, organization, and mode of operation, as well as the taxpayer's own evaluation of its transfer prices under the section 482 regulations. Moreover, the requirement that the taxpayer's analysis be contemporaneous tends to lessen the opportunity to adopt extreme positions that the benefits of hindsight encouraged in the past. Thus, the IRS now has a well-defined starting point for section 482 issues. The IRS no longer has to generate a transfer pricing analysis in a vacuum, but can focus on the analysis contemporaneously prepared by the taxpayer. This focus is salutary for resolution of issues in examination, as well as for resolution of those issues that must go forward to the Appeals or litigation process.

C. <u>Oversight of Transfer Pricing Penalty Assessment</u>

To help promote consistency and uniformity among individual IRS district offices, a Penalty Oversight Committee has been established to review proposed imposition of section 6662 penalties.[25] The committee has representatives from the Assistant Commissioner International, Examinations, Appeals, and Associate Chief Counsel (International).

CHAPTER 3: FIELD DEVELOPMENTS

Administration of transfer pricing rules in the international context is the responsibility of the Office of the Assistant Commissioner (International) (ACT), in conjunction with the Offices of the Assistant Commissioner (Examination) and the Associate Chief Counsel (International). ACT's administration of transfer pricing consists of three major functions: examinations of taxpayers, participation in intergovernmental programs, and implementation of the U.S. tax treaty network. The latter two functions are addressed in Chapter 5. This chapter reviews developments in the examination of transfer pricing issues since the 1992 report.

I. <u>Examination</u>

Transfer pricing issues require substantial factual development. In order to determine whether the results of controlled transactions are consistent with the arm's length standard, the IRS must identify the related entities and the nature of their inter-relationships, understand the underlying transactions, and then evaluate potentially comparable uncontrolled transactions. The IRS must assemble and analyze the data concerning the functions performed, assets used, and risks assumed in the controlled and uncontrolled transactions. Transfer pricing examinations are resource intensive. They typically are tackled by a team of experienced personnel with special training, including, as needed, international examiners (IEs), attorneys, economists, industry specialists, and outside experts.

There are approximately 650 IEs throughout the country devoting about half their time to examining transfer pricing issues. They assist in all Coordinated Examination Program (CEP) examinations that involve international issues. The CEP consists of tax examinations of the 1,500 largest companies in the United

[25] Announcement 96-16, 1996-13 I.R.B. 22 (March 25, 1996).

States, and their domestic and foreign subsidiaries. Although the headquarters of a corporate taxpayer may be in one location, agents from other parts of the country may examine portions of the taxpayer's operations in other locations. In some cases, a CEP audit team may also examine operations located in foreign jurisdictions.

As for other tax issues, the IRS makes a conscientious effort to settle section 482 cases in examination. Most cases involving proposed section 482 adjustments, however, are settled by Appeals, as discussed in Chapter 4.

Section 482 cases that are not settled in Examination or Appeals proceed to litigation, usually in the United States Tax Court. When a Tax Court case is docketed, primary control for the matter passes to the Office of Chief Counsel. Section 482 litigation is discussed further in Chapter 7.

II. <u>International Field Assistance Specialization Program (IFASP)</u>

ACT instituted the International Field Assistance Specialization Program (IFASP) in 1991. IFASP specialists provide IEs with practical assistance regarding technical issue identification and case development in the international area. IFASP includes a team of four senior specialists who travel nationwide to provide transfer pricing expertise and assistance to IEs, IE managers, CEP managers, and economists on particular cases. The IFASP team promotes coordination and consistency for transfer pricing examinations. IFASP coordinates issues and proposed actions as necessary with the Office of the Associate Chief Counsel (International) and with Appeals. IFASP transfer pricing specialists are also frequently assigned to APA teams as advisors.

The IFASP transfer pricing specialists work closely with the IEs. They assist in identifying issues, suggest audit techniques, help search out and evaluate comparables data, and put audit teams with similar issues or industries into contact with one another. IFASP efforts have fostered more efficient audits, better-developed issues, and the identification of trends in section 482 compliance. IFASP plays a central role in IRS training and outreach on transfer pricing topics for both internal and external audiences.

IFASP works on developing coordinated approaches to transfer pricing examinations for particular industries. Specific industry focused projects on which IFASP specialists provided input in recent years include the following:

- Far East and European Automobile Industry
- Camera Industry (foreign-controlled corporations)
- Computer Industry (foreign-controlled corporations)

- Electronic Distributors (foreign-controlled corporations)
- Mexican Produce Growers (imports into the United States)
- Data Processing Industry (consistency in comparable data)
- Forestry/Fishing Industries (cooperative efforts of the U.S. and Canada regarding pricing studies)
- Entertainment Industry (offshore transfer of film intangibles)

IFASP transfer pricing specialists participate in reviewing Code provisions and regulations in need of clarification or revision. IFASP input concerning the need for contemporaneous documentation of taxpayer efforts to comply with the arm's length standard was a significant impetus to the 1993 amendment to section 6662(e). IFASP specialists also contributed to the development of the new regulatory guidance under sections 482 and section 6662(e).

III. <u>Coordination with the United States Customs Service</u>

In 1992 the IRS/Customs Policy board was established. The IRS has been working closely with the United States Customs Service to better coordinate transfer pricing compliance through the IRS/Customs Policy Board and Working Groups:

- Customs provides IRS import data in conjunction with specific examinations and soon IEs will have direct access via intranet to the Customs database.
- Both agencies recognize the need to assess compliance by industry, identifying patterns of noncompliance, and developing examination techniques. For that purpose, Customs provided IRS with its FY99 Audit and Compliance Plans in an effort to help identify industries of common interest. Both agencies are sharing lists of industry and issue specialists in an effort to increase communication.
- Customs is sharing developments in software used to analyze imports, including demonstrations at IRS locations. This software is expected to save IRS research time and help economize on the use of Computer Audit Specialist support.
- Customs recently agreed to provide IRS information pertaining to freight forwarders to assist in the development of examination issues in that industry.
- Customs executives meet every six months with the Southwest Border District Directors to address Mexican border issues.
- National Office Research and Analysis and Southwest District Office Research and Analysis have Customs data pertaining to imports from Mexico and are analyzing that data in conjunction with other compliance initiatives.

For dutiable goods imported in controlled transactions, section 1059A generally limits the cost basis that may be taken into account for income tax purposes to the amount taken into account in computing customs value. Thus, cooperation between IRS and the Customs Service facilitates section 1059A compliance. In addition, the IRS uses customs data as a more general resource in its transfer pricing compliance efforts, with due regard to the limitations of the customs data in that context. For example, there are no customs data for imported or exported services and intangibles, areas of significant transfer pricing controversies.

Section 6103 generally prevents the IRS from releasing tax-return information, even to other Federal agencies pursuant to valid law enforcement purposes. An exception is provided pursuant to section 522 of the North American Free Trade Agreement (NAFTA) Implementation Act, Public Law 102-182, 107 Stat. 2057, codified as section 6103(l)(14), enacted on December 8, 1993. Under this provision, the IRS may release to Customs certain information necessary for Customs officials to determine on audit (or in other actions for collection of revenue), whether entries were correctly reported. This provision and the regulations thereunder prohibit any re-use of the taxpayer information by Customs for any other purpose. See T.D. 8527 (August 1994) (temporary regulations); T.D. 8694 (December 1996) (final regulations).

CHAPTER 4: APPEALS DEVELOPMENTS

This chapter summarizes recent developments in the Appeals process which are relevant to the administration of section 482. Appendix C sets forth sustention rate results for section 482 cases in Appeals.

I. Simultaneous Appeals/Competent Authority Procedure

A new simultaneous Appeals/Competent Authority procedure, described in Rev. Proc. 96-13, 1996-1 C.B. 616, encourages the taxpayer to request joint competent authority assistance and Appeals consideration for double tax issues. This procedure is particularly suited to transfer pricing matters, given the competent authority dimensions typical in such cases. The goal of the new procedure is to expedite resolution of competent authority issues by enabling Appeals to participate actively in the competent authority process.

The revenue procedure sets forth specific circumstances under which the simultaneous Appeals/Competent Authority consideration may be requested and describes the role of Appeals. Taxpayer requests should be made as early in the process as possible after Examination's proposal of a section 482 adjustment, e.g., before a protest is filed or immediately after the first Appeals conference. A taxpayer may also request the simultaneous procedure after competent authority has begun to consider a case, generally until the U.S. competent authority has communicated its position to the foreign competent authority. The U.S. competent authority may also request on its own initiative that Appeals become involved in a case.

As discussed in Chapter 6, in certain cases, the specific transfer pricing methodology developed for prospective application in a bilateral APA may also be used to resolve section 482 issues in prior open tax years, a procedure referred to as a rollback. Rev. Proc. 96-53, 1996-2 C.B. 375, describes the procedures for obtaining a rollback of an APA. The Revenue Procedure provides rules for coordination of APA rollback requests with accelerated competent authority resolution or with simultaneous Appeals/Competent Authority consideration. Small business taxpayers that seek APAs under the newly streamlined procedures (Notice 98-65, 1998-52 I.R.B 10) may also utilize the simultaneous Appeals/Competent Authority procedures.

The simultaneous procedure coordinates Appeals and competent authority consideration in a manner that recognizes the interest of taxpayers in access to Appeals while avoiding the past potential for abuse and inefficiency through iterative resort to both processes. Thus, for example, a taxpayer that received consideration by Appeals without achieving a settlement and that subsequently requests competent authority assistance, may be denied access to the simultaneous procedure. Similarly, a taxpayer that has already received substantial Appeals consideration does not obtain a right to a reconsideration of Appeals' position merely by invoking the simultaneous procedure. Rather, in such cases, the IRS will rely on the previous consideration by Appeals when it considers the case under the simultaneous procedure. If, prior to pursuing competent authority assistance, the taxpayer has already reached a settlement of the transfer pricing issue with Appeals, and that settlement was reduced to writing, the U.S. competent authority will only endeavor to obtain a correlative adjustment from the treaty partner, but will not undertake any action that might undermine Appeals' settlement agreement.

If the competent authorities fail to agree, or if the taxpayer does not accept the mutual agreement reached by the competent authorities, the taxpayer may refer the transfer pricing issue to Appeals for further consideration.

Fifteen simultaneous Appeals/Competent Authority cases have been completed to date and fifteen additional cases are in process. These cases principally involve proposed adjustments under section 482.

II. Alternative Dispute Resolution Initiatives

Section 3465 of the Restructuring and Reform Act of 1998 (RRA 1998) enacted new Code section 7123, which codifies Appeals alternative dispute resolution (ADR) procedures. In addition, the Administrative Dispute Resolution Act of 1996 encouraged federal agencies to use all available ADR techniques in the federal administrative process. In response to growing taxpayer interest, Appeals has developed several new procedures intended to resolve tax disputes, including section 482 controversies, more effectively and efficiently.[26] These procedures are primarily designed to address discrete issues which, if resolved at an early stage, may allow the underlying case to be resolved expeditiously:

- Early Referral. Early referral procedures allow a taxpayer whose return is under examination to request transfer to Appeals of a developed but unresolved issue, while other issues remain in Examination for further development. Early referral and resolution of a key issue may encourage the taxpayer and the IRS to reach agreement on other outstanding issues in the case. Early referral may also save time by enabling Appeals and Examination to work simultaneously on distinct portions of the same case. See Rev. Proc. 96-9,1996-1 C.B. 575, containing the procedures for an early referral request.

- Mediation. A taxpayer whose case is in the administrative Appeals process but not yet docketed in court may pursue mediation. Mediation consists of a negotiation, assisted by an objective and neutral third-party mediator who does not have authority to impose a decision. Mediation may be invoked only after good faith negotiations in Appeals have proven unsuccessful. Mediators may come from Appeals or from outside the IRS. Appeals and the taxpayer generally share the expense of a mediator, but Appeals assumes all the expenses if a member of its staff serves as the mediator.

- Arbitration. Section 7123(b)(2) of the Code requires the Secretary to establish a pilot program whereby a taxpayer and Appeals may jointly request binding arbitration on an issue that remains unresolved at the conclusion of Appeals procedures (or after an unsuccessful attempt to enter into a closing agreement under section 7121 or a compromise under section 7122).

[26] See IRS Initiatives to Resolve Disputes Over Tax Liabilities, GAO Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives, GAO/GGD-97-71 (May 1997).

The new ADR procedures have not had significant application in section 482 cases, because these cases frequently require competent authority assistance and thus are appropriately handled under the simultaneous Appeals/competent authority provisions discussed above.

CHAPTER 5: COMPETENT AUTHORITY DEVELOPMENTS

This chapter summarizes developments in the income tax treaty program since the 1992 report.

I. Intergovernmental Programs

IRS representatives regularly participate in intergovernmental forums for the improvement of international tax administration. Transfer pricing issues frequently receive considerable attention in these meetings. For example, IRS joined its treaty partners in the OECD in the common elaboration of the arm's length principle reflected in the 1995 Transfer Pricing Guidelines and contributes to OECD's ongoing work on those Guidelines. Other forums for these discussions include the Pacific Association of Tax Administrators (consisting of the United States, Canada, Japan, and Australia), the Group of Four (the United States, Germany, France, and the United Kingdom), and the Central Inter-American Center of Tax Administrations (a group of Western-Hemisphere tax administrators).

II. Tax Treaty Program

The United States is a party to 50 income tax treaties and 13 tax information exchange agreements or TIEAs (see Appendix D). ACT functions as the United States competent authority, with responsibility for administering these agreements, issuing technical interpretations and resolving double taxation problems. The Associate Chief Counsel (International) determines the Government's legal interpretation of treaty provisions.

The treaty competent authority process is important to resolution of transfer pricing issues in many cases, because transfer pricing adjustments for U.S. taxpayers often have correlative effects on foreign affiliates, or double tax effect on the taxpayer. The mutual assistance article in the tax treaties provides a mechanism to effectuate relief from international double taxation. In 1996, Rev. Proc. 96-13, 1996-1 C.B. 616, revised the procedure for requesting competent authority assistance (see below).

Under Article 9 of all its income tax treaties (except that with the former U.S.S.R.), the United States and its treaty partners are mutually obligated to apply the arm's length principle to evaluate the controlled transactions of associated enterprises. Further, under Article 25 of most treaties, the United States and its treaty partners must attempt to resolve double taxation issues. Pursuant to Article 26 of most treaties, as well as the provisions of TIEAs, the United States and its counterparts undertake programs to exchange information for income tax compliance purposes, including the resolution of transfer pricing issues. Appendix E sets forth statistics of the recent year results of the competent authority process.

III. Updated Competent Authority Procedure

Article 25 of United States income tax treaties provides for a procedure that affords an opportunity for relief to a taxpayer who believes that an action of the tax authority of one of the treaty countries is contrary to the intent of the treaty.

Transfer pricing cases, including in the bilateral APA context, account for approximately half of the inventory of the U.S. competent authority under this process.

If the U.S. competent authority believes the taxpayer's request has merit, it opens a dialogue with the treaty partner's competent authority and attempts to resolve the matter. Rev. Proc. 96-13 establishes procedures for making a request to ACT, the United States competent authority for treaty purposes. ACT is entitled to consider all the facts and circumstances of the case, as well as the policies underlying the treaty, in deciding whether to accept a case for consideration.

Rev. Proc. 96-13, issued in January 1996, revised the procedures for requesting assistance from the U.S. competent authority. Rev. Proc. 96-13 took into account several internal IRS studies and comments submitted by an ad hoc industry task force. These sources identified difficulties experienced with the mutual agreement procedure. The updated revenue procedure demonstrates a renewed commitment by the United States to the competent authority process.

Important elements of Rev. Proc. 96-13 regarding transfer pricing cases include:

- The U.S. competent authority will be guided by the arm's length principle in seeking to arrive at an agreement with the treaty partner.

- The coordination of competent authority proceedings and Appeals has been revised to prevent procedural abuses, while still giving taxpayers ample opportunity to exercise appropriate administrative appeal rights. The Simultaneous Appeals/Competent Authority procedure allows a taxpayer or the U.S. competent authority to request simultaneous competent authority and Appeals consideration of an issue (see Chapter 4).

- The coordination of competent authority assistance and litigation is clarified.

- Taxpayers must take affirmative protective measures (both in the U.S. and the treaty country) to minimize procedural barriers to implementing any eventual competent authority settlement.

- A new, small case provision encourages competent authority assistance requests when the amounts in issue are relatively small.

- Section 7 of Rev. Proc. 96-53 addresses the coordination of the APA and competent authority procedures in the context of bilateral APAs. If an APA request involves a treaty country, taxpayers are encouraged to seek competent authority agreement with respect to matters that are the subject of the APA.

· Taxpayer may now request an accelerated competent authority procedure to resolve continuing transfer pricing issues for subsequent taxable periods ending prior to the date of the request for assistance.

· Rev. Proc. 96-14, 1996-1 C.B. 626 addresses the coordination of conforming adjustments to reflect primary section 482 adjustments and competent authority assistance. If a taxpayer intends to request competent authority assistance, then any request for treatment under Rev. Proc. 65-17 should be made in conjunction with the request for competent authority assistance. In other treaty cases, a closing agreement under Rev. Proc. 65-17 requires ACT's concurrence.

IV. Treaty Exchange of Information

Pursuant to tax treaties and TIEAs, the IRS conducts exchanges of tax-related information with United States treaty partners, and coordinates simultaneous examinations of specific taxpayers. These programs materially assist the IRS in promoting compliance with the arm's length standard as well as in enforcing other domestic and international tax provisions. The discussion below focuses on the use of these programs in connection with transfer pricing issues.

A. Specific Request for Information Program

The IRS may obtain information from treaty partner tax authorities related to transfer pricing issues for particular taxpayers under audit in the United States. The subject matter of a specific request could include, for example, information concerning foreign persons, their relationship to the U.S. taxpayer, their transactions with the U.S. taxpayer and any comparable transactions with third parties, and similar facts relevant to whether a transfer pricing adjustment is appropriate. Generally, the IRS requests information from the treaty partner only when equivalent information cannot be obtained domestically.

B. Industry-Wide Exchange of Information Program

The industry-wide exchange of information program allows treaty partners to share their cumulative experience regarding a particular industry, as a means of enhancing subsequent examinations of specific taxpayers in that industry. The program, which is closely aligned with the overall Industry Specialization Program, seeks to advance the knowledge of IRS and our treaty partners concerning business operations and transfer pricing practices in specific industries. These industry-wide exchanges of information may reveal the need for an examination of tax issues, and that may lead the treaty partners to simultaneous examinations of specific taxpayers.

In recent years, the IRS has placed increased emphasis on industry-wide exchanges of information with treaty partners relating to transfer pricing practices. To date, successful industry-wide exchanges of information in the transfer pricing area have involved the following industries: pharmaceuticals, oil, grain, data processing, heavy construction, and electronics.

C. Simultaneous Examination Program

In a simultaneous examination, IRS personnel meet face-to-face with the audit team of the treaty partner to exchange factual information regarding specific taxpayers that may have transfer pricing audits in the respective jurisdictions under their respective laws. Simultaneous examinations facilitate flexible and efficient information exchanges. Simultaneous examinations are not a vehicle for negotiation of potential differences which are the subject of the competent authority process.

Simultaneous examinations are undertaken pursuant to working arrangements between the IRS and the treaty partner tax authorities. At present, the United States has twelve such working arrangements, with the following countries: Australia, Canada, France, Germany, Italy, Japan, Korea, Mexico, Norway, the Philippines, Sweden, and the United Kingdom.

D. Other Programs

The IRS also participates in spontaneous and routine exchanges of information with treaty partners. Routine exchange relates to ongoing sharing of information that identifies recipients of passive or investment income, such as dividends, interest, rents, and royalties. Spontaneous exchange relates primarily to the sharing of information discovered in the course of audit that may indicate noncompliance with the tax laws of a treaty partner.

CHAPTER 6: ADVANCE PRICING AGREEMENT PROGRAM

I. <u>Introduction</u>

Under a traditional adversarial approach, the data gathering, development, and analysis of a transfer pricing issue is a complex, time-consuming process which often results in an administrative appeal and litigation. A significant transfer pricing issue can typically take eight or more years to resolve. Developed in 1991 as an alternative to the traditional adversarial process, the Advance Pricing Agreement (APA) Program attempts to resolve transfer pricing disputes in a principled and cooperative manner.

During the 1980s and prior to the creation of the APA Program, the government as well as taxpayers with transfer pricing issues began to explore some sort of an advance pricing agreement mechanism. A 1985 study by a U.S. professional group on how to improve the large case program recommended advance rulings in the transfer pricing area. In 1986, an agenda topic at a meeting of U.S. and foreign tax officials on how to reduce controversies discussed an advance resolution process for transfer pricing. Then, in 1987, Japan developed transfer pricing legislation and subsequently initiated a preconfirmation process on transfer pricing issues. Finally, in 1989, several taxpayers and groups approached the IRS to consider alternative approaches to transfer pricing compliance, viewing the existing means of dealing with transfer pricing issues as being too adversarial as well as unproductive.

The IRS considered new techniques whereby all parties could “buy-in” and share the responsibility for enhancing compliance in the transfer pricing area. Derived from the “Compliance 2000" initiatives, this concept of shared responsibility is also consistent with the current mission statement of the IRS to work with taxpayers “to help them understand and meet their tax responsibilities.” In April of 1989, the IRS announced at a meeting with the Tax Executives Institute that it was considering an advance ruling procedure for transfer pricing issues. The IRS entered into pilot projects with several taxpayers to negotiate and execute what were initially called Advance Determination Rulings but later became known as Advance Pricing Agreements (APAs). In June of 1990, a draft IRS Revenue Procedure for Advance Determination Rulings was publicly disseminated and the first APA was concluded in January of 1991. With the publication of Rev. Proc. 91-22, 1991-1 C.B. 526, the IRS formally initiated the APA Program in March of 1991, and by the end of that year, 15 new negotiations had started. The current revised procedures for APAs are set forth in Rev. Proc. 96-53, 1996-2 C.B. 375.

The APA Program is a cost-effective means of bringing participating taxpayers into section 482 compliance. See Appendix J, setting forth the results of a recent APA costing study and showing that APAs have an average cost of less than $72,000.

II. Current Status of the APA Process

Since 1992, the APA Program's caseload and staffing have steadily grown. Appendix G provides a chronological history of the APA Program through the present. In 1997, the IRS instituted an Early Referral program by which, in appropriate cases, audit teams suggest that taxpayers pursue APAs before substantial time is spent auditing transfer pricing issues. In 1998, the IRS published more streamlined procedures for APAs involving Small Business Taxpayers in an effort to attract smaller taxpayers who may lack the resources to do the sophisticated studies normally included in APA requests. By the end of the 1998 fiscal period, the IRS had concluded four APAs under these streamlined procedures.

The APA Program currently has a Director, two branch chiefs, three economists, and fifteen team leaders, who are either attorneys or accountants. As of the fiscal period ended September 30, 1998, 164 APAs have been concluded with another 186 under negotiation. As outlined in Appendix F, these APAs span a wide range of industries and involve numerous cross-border transactions including sales of tangible property and transfers of intellectual property.

As the United States has become more comfortable with the APA process so has the world. Today, APAs are receiving increased acceptance by many of our treaty partners, including Japan, Canada, Australia, and the United Kingdom. In fact, of the 164 closed APAs, 75 involve our treaty partners through the bilateral process (the bilateral process is discussed below). Currently, the OECD is finalizing guidelines for bilateral APAs, which will likely lead to an even broader acceptance of the APA process by the international community.

III. Purpose and Objectives of the Process

The APA process is designed to enable taxpayers and the IRS to agree on the proper treatment of transfer pricing, including cost sharing arrangements. An APA need not cover all of a taxpayer's pricing arrangements and instead may be restricted to specified years, specified affiliates, and specified intercompany transactions.

APAs may be “unilateral” or “bilateral.” A unilateral APA is an agreement for a prospective period of time between the taxpayer and the IRS on the appropriate transfer pricing method (TPM) for the transactions at issue. With this approach, there is no guarantee that the foreign country’s taxing authority will agree that the TPM is correct. A bilateral APA combines an agreement between the taxpayer and the IRS on a particular TPM with an agreement between the United States and foreign taxing authority regarding the propriety of the TPM, pursuant to the mutual agreement process promulgated in Article 25 of our income tax treaties. As outlined in Appendix F, roughly half of the APAs completed to date have been bilateral. Both unilateral and bilateral APAs may also provide that the agreed-upon TPM be “rolled back” to resolve similar issues for past years under audit.

The APA process focuses on identifying an appropriate TPM, not a desired tax result. The ultimate goal of the APA process is to arrive at an agreement on three basic points: (1) the description of the intercompany transactions to which the APA applies; (2) the TPM to be applied to those transactions; and (3) the arm’s length range of results that is expected after applying the agreed-upon TPM to the covered transactions.

IV. Administrative Details of the APA Process

Within the IRS, the APA Program is located in the Office of the Associate Chief Counsel (International), which is part of the Office of Chief Counsel. This placement reflects the fact that concluding an APA requires negotiating skills, legal analysis, and legal drafting (APAs are essentially contracts between the taxpayer and the IRS). In addition to demanding a variety of skills from the individual members of the APA Program, the APA process also draws on expertise from other offices within the IRS. The APA team typically includes:

- the APA team leader from the APA Program;
- the International Examiner responsible for auditing the taxpayer on transfer pricing issues, and often that IE’s manager and/or the case manager (the manager with overall responsibility for the taxpayer in question);
- an economist, either one assigned to the APA Program or a field economist assigned to assist the Examination team;
- an attorney from the District Counsel office that provides legal advice to the Examination team;

- on bilateral cases, an analyst from the Tax Treaty Division, which is part of the Office of the Assistant Commissioner (International).

V. Key Concepts

A. Standard to be Applied

Section 482 of the Internal Revenue Code permits the IRS to allocate items of income, deductions, credits, or allowances between controlled groups or organizations, “to prevent evasion of taxes, or clearly to reflect the income of any of such organization . . .” or, in the case of transfers of intangible property, to allocate income with respect to the transfer in a manner that is “commensurate with the income attributable to the intangible.”

In determining whether an allocation under section 482 is necessary clearly to reflect a controlled taxpayer’s income, the IRS employs the “arm’s length” standard, a principle which is defined in the attendant Treasury regulations. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. Under current Treasury regulations, the IRS is willing to consider many different approaches to establish the taxpayer’s appropriate intercompany transfer pricing methodology or cost sharing practices, provided these approaches satisfy the arm’s length principle. Any reasonable methodology may be accepted if it clearly reflects income, is supported by available and reliable data, and can be efficiently administered.

This arm’s length approach is also applied for bilateral and multilateral APAs. The OECD Model Tax Convention provides:

> where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

Under the OECD approach, the arm’s length range contemplates “a range of figures that are acceptable for establishing whether the conditions of a controlled transaction are arm’s length and that are derived either from applying the same transfer pricing method to multiple comparable data or from applying different transfer pricing methods.” Comparable language outlining the arm’s length principle is included -- generally in Article 9 -- in most income tax treaties to which the United States is a party.

B. Comparables

The Treasury regulations under section 482 rely on comparable uncontrolled transactions to arrive at an intercompany price that “clearly reflects income” or in the case of intangibles that is “commensurate with the income attributable to the intangible.” Some of the factors that are considered in evaluating comparable transactions include the line of business, accounting and functional differences, volume differences, market level of operation, product maturity, terms of sale, and the capitalization of the tested parties.

C. Public Disclosure

The APA process proceeds from a voluntary disclosure of information by taxpayers to the IRS in an effort to resolve specific transfer pricing issues proposed by the taxpayer. Thus, the confidentiality of the submitted information is an important concern to both the private sector and the government. Because substantial pricing information may be submitted and because transfer pricing issues are unique to each taxpayer, the IRS historically treated an APA request as tax return information exempt from public disclosure under section 6103 of the Internal Revenue Code. However, as a result of a lawsuit filed by the Bureau of National Affairs (BNA), the IRS recently conceded that APAs are the type of written determinations that fall within the scope of section 6110(a). The IRS still maintains that disclosure of APAs is subject to the inherent disclosure limitations contained in Section 6110 as well as subject to the nondisclosure requirements of tax treaties and conventions to which the United States is a party.

VI. Conclusion

The APA process enhances taxpayer compliance by providing an alternative forum to resolve transfer pricing disputes. The success of the APA process is due in part to the coordination and cooperation from all aspects of the APA team including the Examination function. The success of the APA program in resolving transfer pricing issues is evidenced by the increasing acceptance of APAs in the international community. Nevertheless, the IRS continues to identify ways to improve the APA process, as evidenced by the recent small business taxpayer initiative.

Since the enactment in1994 of the final section 482 regulations as well as the additional disclosure and penalty provisions, the APA Program has enjoyed greater success in identifying important transfer pricing issues while at the same time providing greater uniformity with respect to the treatment of those issues. Notwithstanding this increased uniformity, the APA process remains sufficiently flexible to accommodate the unique circumstances of each taxpayer.

The Program's goals originally enunciated in 1991 – principled negotiations and enhanced tax administration – continue to guide the process. In addition to these goals, the direction that the APA Program will follow in the future can be found in the language of the current IRS Mission Statement – to help taxpayers understand and meet their tax responsibilities by applying [transfer pricing concepts] with integrity and fairness.

CHAPTER 7: TAX LITIGATION

This chapter discusses developments in the litigation of section 482 cases since the 1992 report. A sustained commitment to the successful litigation of section 482 cases is an integral part of the IRS tax compliance effort. From a tax administration perspective, litigating such cases serves two purposes: First, it provides guidance in those cases where the outcome establishes legal precedents of general applicability and second, it encourages early voluntary compliance by confirming a willingness to enforce the transfer pricing rules vigorously, when necessary. To achieve those ends, the IRS has expanded programs to ensure earlier identification of compliance issues in cross-border cases generally, better development of the cases, and more efficient allocation of limited litigation resources. These strategies have borne fruit in the form of successful litigation of novel issues related to section 482, better use of resources generally, and enhanced development of related intercompany issues in the context of the possessions tax credit under section 936 et seq. and the withholding at source regime. A list of significant court opinions issued since 1992 in cases in which an adjustment under section 482 was a major issue is provided at Appendix H.

I. Validity of New Enforcement Measures Sustained

The IRS has successfully established precedent upholding enforcement tools in sections 6038A and 6662 to assist in examination of cross-border related party transactions. Section 6038A imposes recordkeeping, reporting, and documentation production obligations, backed up by penalties for noncompliance, intended to assist the IRS in obtaining information from foreign related parties to cross-border transactions. Section 6662 provides for 20% and 40% penalties for underpayments of tax attributable to substantial and gross valuation misstatements. Pursuant to section 6662(e), such penalties attributable to transfer pricing adjustments may be avoided provided the taxpayer undertakes upfront compliance with the arm's length standard as specified in the statute and regulations.

A. Confirmation of Section 6038A Authority

In evaluating controlled transactions to which a foreign person that controls a domestic corporation is a party, key information relating to the function and risk analysis, potential comparables, and other facts may be in the possession of the foreign affiliate, not the controlled domestic corporation. Section 6038A addresses this situation by imposing reporting, recordkeeping, and documentation production obligations, and providing the IRS with summons authority with respect to the related party transactions of foreign-based groups and their 25% or greater U.S. affiliates. In the event that the foreign related party does not authorize the domestic corporation to act as its agent for receipt of such summonses, or fails to substantially and timely comply with a proper summons, section 6038A(e)(3) provides for a noncompliance penalty whereby the IRS in its sole discretion based upon information in its possession determines the domestic corporation's deductions and costs in the related party transaction.

In the first case interpreting section 6038A(e), the Tax Court in ASAT, Inc. v. Commissioner, 108 T.C. 147 (1997), upheld the IRS penalty determination of claimed related party costs and deductions as the result of the taxpayer's noncompliance with section 6038A. In this case, the taxpayer, a U.S. subsidiary of a foreign corporation, failed to furnish an examining agent authorization from its foreign parent for service of summonses, as required pursuant to section 6038A(e)(1), or documents in the possession of the foreign parent in support of positions taken on the return. Using its discretion under section 6038A(e)(3), the IRS issued a notice of deficiency applying a noncompliance penalty adjustment determining that the taxpayer's cost of goods sold would be decreased and that a net operating loss carryforward that originated from the taxpayer's transactions with its foreign parent would be eliminated, and, in the alternative, relied on section 482 for the adjustments. Because resolution of the section 6038A issue had the potential "to negate the need for a trial of issues involving section 482," a separate trial of the section 6038A issue was held. Id. at 148. In sustaining the deficiencies and penalties, the Court held that the IRS determination must be sustained unless the taxpayer could "show by clear and convincing evidence and without reference to information not in respondent's possession or knowledge when the determination was made, that respondent's determination was made with an improper motive or is clearly erroneous in light of all reasonably credible interpretations or assumptions of facts." Id. at 167.

In deciding that the IRS had not abused its discretion, the ASAT, Inc. Court relied on the language of the statute, which provides that the adjustment "shall be the amount determined by the Secretary in the Secretary's sole discretion from the Secretary's own knowledge or from such information as the Secretary may obtain through testimony or otherwise," Id. at 166 (quoting section 6038A(e)(3), emphasis added by the Court). The Court determined that the limited information used by the IRS to make the adjustments to the return was sufficient. In rejecting the taxpayer argument that the merits of the adjustment must be determined on the basis of all evidence available, the Court noted that such a redetermination would be contrary to the purpose of the statute, and stated in pertinent part:

> Petitioner's attack on respondent's results . . . ignores the purpose of the statute. Section 6038A was enacted to insure that the IRS would have either timely access to the information necessary to make a complete analysis of costs between related parties or the right to make an adjustment based solely on the information that it did have. Whether the taxpayer can later justify a cost is irrelevant.

Id. at 171 (citing H. Conf. Rept. 101-386, at 594 (1989)). Based on its resolution of the section 6038A issues, the Court did not reach the section 482 alternative theory.

B. Penalties Applied under Section 6662(e) and (h)

The requirements pursuant to the 1993 amendment and section 6662(e) regulations for taxpayers to contemporaneously document compliance with the arm's length standard, and to promptly provide that documentation to IRS upon request, will mean such documentation should be available at an early stage of an examination. That in turn should promote more frequent resolution of disputes without the need to resort to litigation, or at least a better state of the record at the beginning of litigation. Where such information is not forthcoming, the IRS has demonstrated its willingness to press for its production and assert all available remedies.

In DHL Inc., and Subsidiaries v. Commissioner, T.C. Memo. 1998-461, 76 T.C.M. (CCH) 1122**,** the Tax Court determined that petitioner substantially understated its royalty income and grossly misstated its gains from sale of petitioner's trademark in 1992, without reasonable cause. As a result, accuracy related penalties were sustained at a rate of 20% of the deficiency attributable to the royalty income misstatements, and at a rate of 40% of the deficiency attributable to the gross valuation misstatement of the trademark value. Although the penalty statute applied was that as in effect prior to the 1993 amendment that incorporated the contemporaneous documentation requirements, the Court's analysis of the factors considered in its determination of whether the taxpayer was negligent or had reasonable cause and good faith is helpful in determining how to apply the documentation requirements. DHL argued that it relied in good faith on a contemporaneous appraisal of the trademarks whose transfer was a principal subject of IRS's section 482 adjustments. The Court held the reliance was not reasonable, noting that the appraisal was not requested until after negotiations had established the transfer price that the parties wished to justify, and the parties had informed the appraiser of that goal. 76 T.C.M. (CCH) at 1169. The Court suggested the matter may have been different had the valuation project been assigned to an independent valuation entity before any values were placed on the trademark, or had the parties not advised the evaluator of a value. Id.

II. Litigation Remains a Necessary Means of Section 482 Administration

Because these cases typically revolve around complex factual valuation issues, they require the devotion of an enormous amount of resources on the part of the IRS, the courts, and the taxpayers. See Appendix I, detailing costs incurred by the IRS in litigating two recent section 482 cases. Nevertheless, the cost of litigation cannot be a controlling factor when deciding whether to litigate. Otherwise, tactical delay in producing information until a case has reached the Court would yield enormous advantage to uncooperative taxpayers. Several recent cases illustrate the difficulty faced by the IRS in determining an appropriate reallocation and defending such reallocation when information is not forthcoming until after a controversy reaches court. Although the reallocations sustained by the Court were greatly reduced from those initially determined by the IRS, substantial adjustments to the position taken on the return were sustained nevertheless.

In DHL, the taxpayer's dilatory conduct in responding to IRS requests for information contributed to IRS's inability to provide the taxpayer with any notice or report of the proposed adjustments before issuance of the notices of deficiency and to IRS's need to reduce its proposed adjustments in light of information acquired only after issuance of the notices of deficiency. 76 T.C.M. (CCH) at 1142-45. The Court was inconvenienced as well, and noted that procedural accommodations were necessitated as the result of the taxpayer's dilatory compliance and untimely production of information to the IRS, "which continued into the middle portion of a lengthy trial." Id. at 1166 n.28. As discussed above, the misstatements of transfer prices were ultimately established by the IRS to the Court's satisfaction. The availability of, and willingness to commit, sufficient resources to support the trial team's continued effort to secure and analyze the necessary information were critical to that outcome.

In Seagate Tech., Inc., & Consol. Subs. v. Commissioner, 102 T.C. 149, 171 (1994), the IRS made numerous concessions in light of information not obtained until preparation for trial. Seagate was a leading manufacturer of hard disk drives for personal computers, and IRS reallocated $285,396,000 from Seagate Singapore to taxpayer pursuant to section 482. Although the Tax Court held that the IRS's reallocation was arbitrary, capricious, and unreasonable, the court nevertheless determined that a reallocation of a lesser amount was necessary. In doing so, it held that the royalty rate in the property transfer agreement, the transfer prices for the component parts and complete disk drives, and the taxpayer's allocation of research and development costs were not arm's length. The estimated income allocation sustained by the court was over $40 million.

In Medieval Attractions N.V. v. Commissioner, T.C. Memo 1996-455, 72 T.C.M. 924, 929 (1996), the Tax Court agreed with the IRS's arguments that numerous transactions were devoid of economic substance and necessitated reallocations to clearly reflect income. Spanish investors formed various Netherlands Antilles, Netherlands and United Kingdom companies to hold their interests in a Spanish corporation. The Antilles corporations formed various U.S. corporations, first in Florida and later in California and New Jersey, to develop and operate medieval dinner theaters in the United States. The U.S. entities paid "franchise fees", "royalty" payments for use of the intangibles and marks, and various "management fees" to these Netherlands Antilles entities, which, in turn, paid "interest" and "guarantee fees" ultimately to the Spanish investors. The Tax Court denied deductions for interest on various promissory notes paid by a group of U.S. corporations that operated the entertainment facilities because no genuine indebtedness existed. Royalty payments lacked economic substance and were shams undertaken solely for tax-avoidance purposes. Certain franchise and royalty expenses paid by the U.S. entities represented income to nonresident alien individuals or foreign corporations, and distribution, apportionment, or allocation of those amounts was necessary in order to prevent evasion of taxes and to clearly reflect income. The Court applied the negligence, substantial understatement and increased interest penalties.

The "Aramco Advantage" cases were also decided since the April 1992 report. Accepting the taxpayers' position in Exxon Corp. v. Commissioner, T.C. Memo. 1993-616, aff'd sub nom. Texaco Inc. v. Commissioner, 93 F.3d 825 (5th Cir. 1996), cert. denied 520 U.S. 1185 (1997), the Tax Court held that a Saudi Arabian pricing restriction was the "substantial equivalent of foreign law" that can preclude a section 482 adjustment. The pricing restriction in dispute was a price ceiling on sales of Saudi crude by the U.S. corporations who purchased the oil from the government controlled oil company, ARAMCO. The restriction was imposed by a letter from the Saudi Arabian Oil Minister (the so-called "Yamani Edict"). However, taxpayers' foreign affiliates were not subject to the Yamani Edict, and reaped the

Aramco Advantage by processing the low-cost Saudi crude and selling the resulting products at world market prices. Viewing the the Saudi-imposed price restriction as a condition of sale imposed in the context of a commercial relationship, rather than a legal restriction, the IRS determined that an arm's length price for Exxon's and Texaco's sales of Saudi crude oil to their related refiners exceeded the price purportedly permitted, and reallocated the Aramco Advantage income from the foreign affiliates to the taxpayers. The Tax Court held that the price restriction was a legal restriction sufficient to preclude a section 482 reallocation, applying the principles of Commissioner v. First Security Bank, 405 U.S. 394 (1972) as interpreted in Procter & Gamble v. Commissioner, 95 T.C. 323 (1990). aff'd 961 F. 2d 1255 (6th Cir. 1992). In the IRS's appeal of Texaco, the Fifth Circuit affirmed. The section 482 regulations that became final in 1994 now provide that a foreign legal restriction, whether temporary or permanent, will be given effect only to the extent that it affects the results of transactions at arm's length. Treas. Reg. § 1.482-1(h)(2). The IRS believes that, had this regulation been applicable to the years before the Tax Court in Texaco, the Court would have reached a different result without violating the principles enunciated in Commissioner v. First Security Bank, supra.

III. Changes in Managing Transfer Pricing Issues Since 1992

A. Strategies

As part of an IRS wide effort to frontload technical expertise in cases to either mitigate the need for litigation or better develop those cases that result in litigation, since 1992, the Office of Associate Chief Counsel (International) (ACCI) has refined and expanded its program to manage case development, information gathering abroad, and coordination of technical issues within International and with other functions of Chief Counsel, the Assistant Commissioner (International), Treasury and Justice. Staff with both substantive tax expertise and litigation experience serve as a link between the technical branches and field personnel in Counsel, Appeals and Examination as well as IFASP, to provide advice on tax controversies at all stages. Together with branch personnel they coordinate and review Tax Court, refund and summons enforcement litigation at the trial and appellate levels. Concomitant with that coordination and Counsel-wide procedures, all newly docketed cases with a disputed amount of tax over $1 million and an international issue are screened upon receipt. Cases with potential tax administration significance, issues with industry wide significance, or particularly complex or large dollar adjustments are identified through this process and selected for the closer coordination under the Large Case Procedures. A copy of the Chief Counsel Directives outlining those procedures is attached as Appendix K.

This screening process, together with frequent informal assistance to IFASP specialists, has a practical effect of providing early review of almost all cases arising under section 482. If a case is included in that program, ACCI participates in the development and review of workplans, technical positions and litigation strategy. Attorneys from ACCI will review, and in some instances prepare, trial briefs and other significant filings, and coordinate appellate litigation. On several occasions, attorneys from ACCI have been members of trial teams. Regardless of whether a case is handled under the Large Case Procedures, the goal is to provide effective legal services to the field, while preserving consistency in the nationwide enforcement of the Code with respect to international matters. The success of the Large Case Procedures in international section 482 litigation is evidenced by the fact that both ASAT and DHL fell within the program.

B. Limits on Ability to Manage Transfer Pricing Litigation

Several extrinsic factors constrain the ability of the IRS to maximize the effectiveness of its transfer pricing litigation. Overall, IRS strategy has been to encourage settlement of section 482 cases that reach the courts and to litigate only those cases that present broad compliance issues, such as ASAT and DHL. However, regardless of the willingness of the IRS to settle a case rather than consume resources on inherently factual issues of little or no administrative significance, any such settlement must be grounded in facts and law and is subject to the acceptance of the other party. If that party is determined to go to trial, the IRS may have little choice but to proceed to litigation. Second, the discretion of a judge in case management, derived from Fed. Rule Civ. Proc. 16, is extremely broad, with the result that special orders may be entered that set unanticipated limits on discovery schedules and trial times or impose special filing requirements. Because the various judges differ in the extent to which they solicit the parties' views in determining pretrial schedules, the impact of a case assignment can not always be predicted. Finally, the Tax Court's limits on discovery continue to have an impact in section 482 cases because it remains the only prepayment forum available to taxpayers and its rules significantly limit the use of depositions for discovery purposes, in Rules 74 and 75 of the Tax Court Rules of Practice and Procedure.

C. Section 482 Management and Related Issues

Lessons learned in strategically managing the transfer pricing cases have had a beneficial effect in developing the cases arising under provisions other than section 482, but requiring intensive factual development of intercompany practices, as in the case of corporations claiming the possessions credit. For instance, the Tax Court held that prices charged to Altama Delta by its Puerto Rican subsidiary were not arm's length, adjusting the subsidiary's gross profit margin based on the court's "best estimate" of appropriate transfer prices. In doing so, the Court held that the Puerto Rican subsidiary's gross profit margin for 1985-87 should be equal to the 19.2% gross profit margin the parent company averaged for 1986-87. The court also found that the subsidiary owed a cost sharing payment under section 936(h)(5)(C)(i)(III)(a). Altama Delta Corp. v. Commissioner, 104 T.C. 424 (1996)

Enforcement of section 482 reallocations includes the use of the "withholding at the source regime" to collect the resulting tax deficiency from the U.S. party to the transaction. Although the precise issue of whether a section 482 allocation of U.S. source income to a foreign entity is subject to section 1442 withholding has not been addressed by a court, there is case law to support such an approach. The IRS strategy is to ultimately confirm the point in an appropriate case. In an unpublished opinion, interest imputed to a foreign related entity under section 7872 was held to be subject to withholding. Climaco and Nakamura v. Internal Revenue Service, 96-1 USTC ¶ 50,153 (E.D.N.Y. 1996) (unpublished opinion, Jan. 24, 1996).

The government's position in Climaco was based on Casa de la Jolla Park, Inc. v. Commissioner, 94 T.C. 384 (1990) and Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994). In Casa de la Jolla Park, Inc., a US corporation was held liable for withholding tax on interest constructively received by its sole shareholder on the corporation's promissory note as a result of the authorized remittance of corporate sales proceeds to a foreign creditor of the shareholder. In so holding, the Tax Court rejected arguments that withholding obligations require actual payment and receipt, and invoked the constructive receipt doctrine. In Central Gas de Chihuahua, the Court rejected an analogous taxpayer argument that an actual payment, rather than a reallocation under section 482, is required for imposition of tax under section 881 on the deemed recipient of income. Because that case involved the foreign recipient, rather than the deemed payor, the Court did not address the withholding obligation of the payor under section 1441.

Recently issued final regulations under section 1441 (Treas. Reg. § 1.1441-2(e)(2)) specifically provide that an allocation of income subject to withholding under section 482, as well as income arising as a result of a secondary adjustment made in conjunction with a reallocation of income from a foreign person to a related U.S. person, is subject to withholding under section 1441. While this regulation is not yet effective, we view the new regulation as consistent with currently applicable law on this point. It is also worth noting that the IRS enforcement of section 482 in the imputed interest context is often met with a taxpayer disavowal of the form of its intercompany transactions to avoid the section 482 allocation. To date, the IRS has relied on the principles of Commissioner v. National Alfalfa Dehydrating and Milling Co., 417 U.S. 134 (1974) to hold the taxpayer to its chosen form. See also, Taiyo Hawaii, Ltd., v. Commissioner, 108 T.C. 570, 601-603 (1997) (imposition of excess interest tax pursuant to section 884).

CHAPTER 8: RECOMMENDATIONS AND CONCLUSIONS

The IRS intends to continue to pursue its five-part strategy to improve the administration of section 482. Thus, the IRS plans a combination of section 482 guidance, promotion of upfront compliance with the arm's length standard, strengthening the international consensus on transfer pricing guidance and compliance, advanced resolution of transfer pricing issues in the APA Program, and strategic management of section 482 issues in litigation.

With respect to compliance measurement, Chapter 1 concludes that the annual gross tax gap due to noncompliance with section 482 is $2.8 billion. Chapter 1, however, calls attention to a number of possible biases in this number -- both upward and downward. Many of these biases arise from the fact that this study relies upon operational audit data to measure the tax gap. Operational audits, while accurately reporting the results of IE activity, have important limitations when used to extrapolate compliance or non-compliance to the entire universe of taxpayers. Chapter 1 also concludes that the available data from the operational audits is inconclusive as to whether the section 6662(e) penalties and the 1994 final section 482 regulations have improved compliance. This inconclusiveness is in substantial part due to the fact that operational audit results are subject to a variety of factors that make compliance trends difficult to detect using this data. It seems clear that if the IRS is to more accurately measure the section 482 tax gap or to measure trends in section 482 compliance, alternative methodologies should be considered.

There are at least two alternatives that could be considered, depending on the desired result. If measuring the absolute value of the section 482 tax gap is the desired end, there are a number of improvements that could be made to the methodology adopted in this report. In particular, the operational audit data could be supplemented with information regarding the broader class of taxpayers with potential transfer pricing issues. For example, information from Schedule M of Form 5471 "Transactions Between Controlled Foreign Corporations and Shareholders or Other Related Persons," Form 5472 "Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business," and once it is finalized, Schedule H of the proposed Form 8865 "Transactions Between Controlled Foreign Partnership and Partners or Other Related Entities" could be used to supplement the operational audit data available on transactions between commonly controlled taxpayers. In addition, there are certain advanced econometric methods that might be applicable to mitigate the lack of randomness inherent in the selection of taxpayers for operational audits. Extending the tax gap methodology to include these data and techniques could require a substantial commitment of time and resources. It is likely, however, that such an extended methodology would provide a better measure of the section 482 tax gap.

While the extended tax gap methodology described in the preceding paragraph could improve the measurement of the gross section 482 tax gap, there is some doubt whether even this better measure of the tax gap could demonstrate whether section 482 compliance is improving, getting worse, or remaining constant. This is because in order to spot compliance trends, a high level of precision is required in the measurement. Particularly with respect to measuring changes in compliance over time, it is vital that a compliance measurement methodology control for extraneous issues that can affect the results of audits conducted at different time periods. In order to obtain the relatively high precision required to measure compliance trends, it is possible that the IRS would have to undertake special audits designed to investigate taxpayer compliance with section 482. Obviously such an effort would be a major undertaking. However, the continuing importance of section 482 compliance to tax administration may militate in favor of such research.

With respect to improving the section 482 guidance described in Chapter 2, the IRS contemplates several regulations projects on transfer pricing issues. The regulations on global dealing are to be finalized in the near future and consideration is being given to whether a similar approach may be adapted for other interbranch issues. Attention may be addressed to clarifying the application of the detailed principles enunciated in the 1994 section 482 regulations to interaffiliate services as well as to further elucidating the treatment of intangibles, including marketing intangibles. The IRS will also complete its revision of the revenue procedure on conforming accounts to reflect section 482 adjustments.

The shift to upfront compliance with the arm's length standard should reduce transfer pricing controversies or provide a desirable focus for those that do arise. The IRS will continue its initiatives to resolve transfer pricing cases in Examination and Appeals, to avoid double taxation via the competent authority process, and to vigorously litigate unresolved cases, as appropriate. The IRS will similarly continue its involvement in the ongoing work of the OECD on the Transfer Pricing Guidelines, as well as its participation in other multinational forums, to help ensure international consistency and uniformity in the application of the arm's length principle.

The IRS will further its emphasis on the APA Program as a means of advance resolution of transfer pricing issues that provides protection against domestic and foreign adjustments and penalties. Moreover, as it was with respect to global dealing, the APA Program will be a laboratory to identify and formulate appropriate approaches to particular transfer pricing issues which then can be incorporated into guidance.

With regard to the Field, Appeals, Competent Authority, and the Advance Pricing Agreement program described in Chapters 3 through 7, the IRS Restructuring and Reform Act of 1998 has prompted the most significant reorganization of the IRS in 40 years. This modernization effort at this time is a work in process and the available information must be considered preliminary. As a consequence, it is difficult to develop recommendations with regard to the IRS organization and section 482. The reorganization is expected to alter the existing structure in many significant ways. The preliminary indications are that the reorganization will take appropriate account of the particular functions of the International Examiners, Appeals, Competent Authority, and the Advance Pricing Agreement program. The IRS's focus on section 482 compliance will not be lost and should, in fact, benefit from the new organization.

APPENDICES

APPENDIX A
Estimated Section 482 Gross Tax Gap

Average Annual Estimated Section 482 Gross Tax Gap (In $ millions), By industry Group, Size Class and Type of Corporation, FY96 - FY98

Industry Group	Asset Size Class	FCC's	Non-FCC's	Total
Manufacturing	Total	976	448	1,424
	Small	81	46	126
	Mid-size	334	(33)	301
	Large	561	436	996
Wholesale and Retail Trade	Total	746	144	890
	Small	81	72	153
	Mid-size	479	51	530
	Large	186	21	207
Finance, Insurance and Real Estate	Total	139	88	227
	Small	21	1	22
	Mid-size	67	18	85
	Large	50	69	120
Services	Total	139	21	160
	Small	37	1	38
	Mid-size	82	9	91
	Large	20	11	31
Other Industries	Total	14	117	130
	Small	15	0	15
	Mid-size	(5)	4	(1)
	Large	3	113	116
Total	Total	2,013	818	2,831
	Small	235	120	355
	Mid-size	957	49	1,005
	Large	821	649	1,471

Portion of Section 482 Tax Gap Identified in Audits

Asset Size Class	Gross Tax Gap	Portion of Gross Tax Gap Identified in Audits		Portion of Gross Tax Gap Not Identified In Audits	
	$M	$M	Percent	$M	Percent
Small	355	39	11%	316	89%
Mid-size	1,005	220	22%	786	78%
Large	1,471	1,471	100%	0	0%
Total	2,831	1,729	61%	1,102	39%

APPENDIX B
Analysis of Compliance Trends

Tax Period Group ings	Closing Period	Returns Closed	Adjustments Proposed $'s per return	Avg. Proposed $'s per return	Standard Deviation - adj	Hours Expended	Avg. Hrs Per return
All Returns							
92 and 93	97 total	202	334,290,128	1,654,902	6,253,902 **std error** **440,023**	29,302	145
94 and 95	99 Total	702	580,058,258	826,294	4,202,696 **Std. Error** **158,621**	74,699	106
Difference				828,608	**Std. Error** **467,740** t-statistic 1.77		
CEP							
92 and 93	97 total	51	159,789,089	3,133,119	11,527,437 **Std error** **1,614,164**	13,102	257
94 and 95	99 Total	100	379,482,939	3,794,829	9,334,961 **Std. Error** **933,496**	21,024	210
Difference				(661,710)	**Std. Error** **1,864,656** t-statistic (0.35)		
Non-CEP							
92 and 93	97 total	151	174,501,039	1,155,636	2,668,579 **Std. Error** **217,166**	16,200	107
94 and 95	99 Total	602	200,576,319	333,182	2,130,090 **Std. Error** **86,816**	53,674	89
Difference				822,454	**Std. Error** **233,876** t-statistic 3.52		

APPENDIX C
Appeals Sustention Rate in Section 482 Cases

The sustention rate in Appeals is defined as the percentage of adjustment dollars proposed by Examination that is actually agreed to in Appeals. For example, if the Field proposed an adjustment of $100x and Appeals approved a settlement for $20x, the sustention rate is 20%.

In practice, the sustention rate may be affected by the disposition of issues outside Appeals' jurisdiction. For example, if Appeals fails to obtain settlement with respect to a particular issue and sends that issue forward to Counsel for trial preparation, the issue does not factor into the sustention rate. In such cases, although the issue was not conceded by Appeals, neither was it actually settled or agreed. Moreover, in computing the sustention rate, any amount conceded by Appeals due to a judicial decision for an earlier audit cycle for the same taxpayer that also affects the audit cycle before Appeals, is also taken into account. Similarly, the results of a Simultaneous Appeals/Competent Authority agreement on an issue under Appeals' jurisdiction is included in computing the sustention rate. Thus, although the sustention rate in part reflects the percentage of Examination's proposed adjustment that is upheld in Appeals, the rate is also affected by the foregoing extrinsic factors.

In settling disputed issues such as transfer pricing adjustments, Appeals considers the hazards of litigation in an effort to reach a resolution that is fair to both the taxpayer and the Government. Hazards of litigation center around disagreements regarding the facts and the law. Appeals must consider the facts and the law in arriving at an answer that a court would be likely to reach. In most cases, both factors are in dispute, or are not fully developed. In a fact intensive, heavily litigated area such as transfer pricing, assessing the hazards of litigation is a case specific inquiry. The assessment takes into account the facts of the case and the likely application of the law, including relevant judicial decisions. Given the difficulty of developing these cases, particularly the cases currently before Appeals which predate the new regulations governing contemporaneous documentation of compliance with the arm's length standard, and the difficulty of litigating these issues to conclusion, the hazards are generally significant.

Appeals tracks the five largest issues in the CEP cases that it considers. Although this issue tracking system is not complete, it monitors disposition of the most significant issues in the largest cases before Appeals. Based on data from this system, since October 1, 1994, the sustention rate on section 482 issues in Appeals was 27% ($8,127,494,906 proposed by Examination, of which $2,207,444,606 was agreed in Appeals). For calendar year 1998, the sustention rate was 34.22% ($3,754,558,544 proposed by Examination, of which $1,284,730,936 agreed in Appeals).

APPENDIX D
Competent Authority - Income Tax Treaties and TIEAs

The United States is a party to fifty income tax treaties in force,[27] with the following countries:

Australia	Egypt	Israel	New Zealand	South Africa
Austria	Finland	Italy	Netherlands Antilles[28]	Spain
Barbados	France	Jamaica	Norway	Sweden
Belgium	Germany	Japan	Pakistan	Switzerland
Bermuda[29]	Greece	Kazakhstan	Philippines	Thailand
Canada	Hungary	Korea	Poland	Trinidad/Tobago
China	Iceland	Luxembourg[30]	Portugal	Tunisia

[27] The Senate has approved the Ukraine income tax treaty, but instruments of ratification have not been exchanged due to concerns about Ukraine's bank secrecy laws.
[28]The treaty is terminated to the extent provided in the protocol effective December 30, 1996.
[29] The income tax treaty with Bermuda relates only to taxation of insurance enterprises and mutual assistance in tax matters.

Cyprus	India	Mexico	Romania	Turkey
Czech Republic	Indonesia	Morocco	Russia	USSR[31]
Denmark	Ireland	Netherlands	Slovak Republic	United Kingdom

The United States has entered into a total of thirteen TIEAs, with the following countries:

Barbados	Dominica	Guyana	Marshall islands	St. Lucia
Bermuda	Dominican Republic	Honduras	Mexico	
Costa Rica	Grenada	Jamaica	Peru	

[30]The Senate has approved a new Luxembourg income tax treaty, but instruments of ratification will not be exchanged until instruments of ratification for a treaty for mutual legal assistance in criminal matters are also exchanged at the same time.

[31] The US-USSR income tax treaty applies to the countries of Armenia, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine and Uzbekistan. The status of Azerbaijan is not clear.

APPENDIX E
Competent Authority Statistics

1. Volume

The number of requests for U.S. competent authority assistance tends to fluctuate from year to year, but has generally increased over the past several years, as the following chart indicates. However, over the same period, the number of APAs has more than doubled from 54 at the end of FY 1994 to 123 by the end of FY 1998:

	Non-Allocation	Allocation	APA	Total
FY 1995				
Inventory 10/94	177	115	54	346
Receipts	92	84	33	209
Closure	79	70	9	158
Inventory 9/95	190	129	78	397
FY 96				
Inventory 10/95	190	129	78	397
Receipts	99	61	59	219
Closure	55	85	20	160
Inventory 9/96	234	105	117	456
FY 97				
Inventory 10/96	234	105	117	456
Receipts	124	55	39	218
Closure	104	51	35	190
Inventory 9/97	254	109	121	484
FY 98				
Inventory 10/97	254	109	121	484
Receipts	83	62	33	178
Closure	125	58	31	214
Inventory 9/98	212	113	123	448

Allocation Cases: cases involving transfer pricing issues
Non-Allocation Cases: cases involving other issues, such as withholding tax

APA: Advance Pricing Agreement

2. Relief Effected

The relief percentages are computed based on dollars amounts. Consequently, one very large case could conceivably affect the smaller categories, such as Partial and No Relief. The following statistics show the degree to which taxpayers were relieved from double taxation on all cases:

	1995	1996	1997	1998
FULL RELIEF				
Correlative Adjustment	49.12%	50.30%	52.87%	41.09%
Adjustment Withdrawn	41.90%	38.22%	46.17%	45.96%
PARTIAL RELIEF	0.41%	0.00%	0.19%	8.20%
NO RELIEF	8.58%	11.48%	0.78%	4.45%

"Full Relief" has two components:

1) Correlative Adjustment - the U.S. or the treaty partner allows a corresponding adjustment.

2) Adjustment Withdrawn - the initiating country withdraws the adjustment.

"Partial Relief" means that the taxpayer received a foreign tax credit because no agreement was reached (treaty partners unable to agree or relief barred by statute of limitations).

"No Relief" means the taxpayer does not receive relief that the competent authority process ordered (e.g., taxpayer withdraws and seeks a settlement outside of competent authority, treaty partners unable to agree, statute of limitations bars adjustment and tax not creditable).

Note these statistics are for Allocation and Non-Allocation cases only and do not include APA cases.

3. Processing time

The program ordinarily comes close to its goal of 730 days to resolve the average case:

	Open Cases		Closed Cases	
	Cases	Days	Cases	Days
FY 95				
U.S. – Init.	156	458	64	656
Foreign-Init.	163	453	85	597
Combined	319	455	149	622
FY 96				
U.S. – Init.	174	624	48	533
Foreign-Init.	165	492	92	555
Combined	339	560	140	547
FY 97				
U.S. – Init.	195	518	74	933
Foreign-Init.	168	552	81	670
Combined	363	538	155	807
FY 98				
U.S. – Init.	149	627	103	726
Foreign-Init.	176	534	80	806
Combined	325	577	183	761

Note these statistics are for Allocation and Non-Allocation cases only and do not include APA cases.

APPENDIX F
APA Statistics

Participants in the APA program span a wide spectrum of industries. For the 164 APA cases closed as of September 30, 1998, the industries that have been represented include:

-Financial products (22)
-Computers (16)
-Consumer Products - Retail (27)
-Consumer Electronics (11)
-Petroleum\Chemical (10)
-Automotive (14)
-Manufacturing\Industrial (24)
-Biotech\Pharmaceuticals (8)
-Oil Gas (4)
-Aluminum\Steel (2)
-Aerospace (5)
-Publishing (2)
-Food (7)
-Shipping (1)
-Telecommunications (5)
-Software (1)
-Construction (4)
-Entertainment (1)

The following chart summarizes the number of new APA cases that have been filed and completed over the past eight years. Included in this chart for completed cases is information identifying whether the APA was bilateral or unilateral and the region where the APA originated.

Year	*New Cases*	*Completed Cases / (Unilateral / Bilateral) / By Region*				
		Total (U/B)	Northeast	Midstates	Southeast	West
1991	15	1 (1 U)			1	
1992	21	5 (2U / 3B)	5			
1993	34	10 (8U / 2B)	5	1	2	2
1994	41	3 (3U)	3			
1995	58	21 (14U / 7 B)	11	4	1	5
1996	60	32 (16U / 16B)	18	6	4	4
1997	65	41 (27U / 14B)	19	10	5	7
1998	63	51 (18U / 33B)	35	7	5	4

APPENDIX G
APA Significant Developments -- 1992 To Present

September, 1992 By fiscal year end, the APA Program had completed 6 APAs.

September, 1993 APA Task Force Report issued: "Implementation Issues for a More Effective APA Program." This report addressed the issue of whether the APA Program should stay as part of the Office of Chief Counsel or should instead be placed under the Assistant Commissioner (International). The APA Program remained within the Office of Chief Counsel, but with a recognition that the APA Program's multifunctional nature requires close coordination with the Office of the Assistant Commissioner (International).

September, 1993 By fiscal year end, the APA Program had completed 16 APAs.

February, 1994 Proposed and temporary transfer pricing penalty regulations published. These regulations provided additional incentive for taxpayers to request APAs, to avoid possible substantial penalties if substantial transfer pricing adjustments were sustained. (Revised proposed and temporary regulations issued July, 1994; final regulations issued February, 1996.)

April, 1994 Notice 94-40 (1994-1 C.B. 351) issued, titled Global Trading Advance Pricing Agreements. This Notice gave guidance to financial institutions that conduct round-the-clock trading, passing their book of investments from (for example) New York to London to Tokyo over a 24-hour period.

September, 1995 By fiscal year end, the APA Program had completed 40 APAs.

September, 1996 By fiscal year end, the APA Program had completed 72 APAs.

November, 1996 IRS Chief Counsel Directives Manual part (42)(10) issued, setting out internal procedures for processing APA cases.

December, 1996 Rev. Proc. 96-53 (1996-2 C.B. 375) issued, providing revised procedures for APAs.

August, 1997 Early Referral Program instituted, effective October 1, 1997, by which districts selectively refer appropriate taxpayers with transfer pricing issues to apply for an APA before the issue receives substantial audit attention.

September, 1997 By fiscal year end, the APA Program had completed 113 APAs.

February, 1998 Notice 98-10 (1998-6 I.R.B. 9) issued, providing draft procedures for Small Business Taxpayer APAs. (Small businesses, defined generally as having under $100 million worldwide sales, were previously eligible for APAs; however, the draft procedures were designed to encourage smaller corporations to participate in the APA program by making the process more streamlined and less expensive.)

September, 1998 By fiscal year end, the APA Program had completed 164 APAs, including its first four APAs under the Small Business Taxpayer procedures.

December, 1998 Notice 98-65 (1998-52 I.R.B. 10) issued, providing final procedures for Small Business Taxpayer APAs. (Small business redefined as generally under $200 million worldwide sales.)

APPENDIX H
Significant Section 482 Docketed Cases

This appendix provides information on sixteen significant court opinions published after 1992 in cases in which an adjustment under section 482 was a major issue. The opinions are listed both by year of publication and by alphabetical order. The alphabetical list includes synopses of those cases not discussed in the text of the report.

Annual List:

1993:

- Perkin-Elmer Corp. v. Commissioner, T.C. Memo. 1993-414, 66 T.C.M. (CCH) 634

- Apple Computer Inc. v. Commissioner, T.C. Docket No. 21780-90

- Exxon Corp. v. Commissioner, T.C. Memo. 1993-616, 66 T.C.M. (CCH) 1707, aff'd sub. nom. Texaco Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996), cert. denied 520 U.S. 1185 (1997)

1994:

- Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994)

- Seagate Tech., Inc., & Consol. Subs. v. Commissioner, 102 T.C. 149 (1994)

- National Semiconductor Corp. v. Commissioner, T.C. Memo. 1994-195, 67 T.C.M. (CCH) 2849

1995:

- W.L. Gore Inc. v. Commissioner, T.C. Memo. 1995-96.

1996:

- InverWorld v. Commissioner, T.C. Memo. 1996-301, 71 T.C.M. (CCH) 3231

- Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455, 72 T.C.M. (CCH) 924

1997:

- Gibbs International, Inc. v. Internal Revenue Service, 1997 U.S. App. LEXIS 30504 (4th Cir. Nov. 7, 1997), cert. denied, 118 S.Ct. 1512 (1998)

- Pikeville Coal Co. v. United States, 37 Fed. Cl. 304, 97-1 U.S.T.C. ¶ 50,256 (1997)

- Kaps Warehouse, Inc. v. Commissioner, T.C. Memo 1997-309; 74 T.C.M. (CCH) 18

- ASAT v. Commissioner, 108 T.C. 147 (1997)

1998:

- Podd, et al. v. Commissioner, T.C. Memo 1998-231; 75 T.C.M. (CCH) 2575

- Kenco Restaurants, Inc. v. Commissioner, T.C. Memo. 1998-342, 76 T.C.M. (CCH) 512; appeal to the 6^{th} Circuit docketed.

- DHL Corp. v. Commissioner, T.C. Memo. 1998-461, 76 T.C.M. (CCH) 1122

1999 (through March 31, 1999):

None

Alphabetical List of Opinions:

Apple Computer Inc. v. Commissioner, T.C. Docket No. 21780-90

In September of 1993, Judge Jacobs announced that an arbitration panel accepted the Service's transfer pricing figures for the three years at issue in binding "baseball" arbitration. Transfer Pricing Report, September 22, 1993, and October 20, 1993.

ASAT v. Commissioner, 108 T.C. 147 (1997)

Central de Gas de Chihuahua v. Commissioner, 102 T.C. 515 (1994)

DHL Corp v. Commissioner, T.C. Memo. 1998-461, 76 T.C.M. (CCH) 1122

Exxon Corp. v. Commissioner, T.C. Memo 1993-616, aff'd sub nom. Texaco Inc. v. Commissioner, 93 F. 3d 825 (5th Cir. 1996), cert. denied 65 U.S.L.W. 3711 (1997)

Gibbs International, Inc. v. Internal Revenue Service, 1997 U.S. App. LEXIS 30504 (4th Cir. Nov. 7, 1997), cert. denied, 118 S.Ct. 1512 (1998)

The Fourth Circuit affirmed a decision of the U.S. District Court for the District of South Carolina that the Service was not required to disclose under FOIA a letter that the Service wrote to German tax officials suggesting that they participate in a simultaneous tax examination of the taxpayer and its German subsidiary.

InverWorld v. Commissioner, T.C. Memo 1996-301, supplemented by T.C. Memo 1997-226

The Tax Court found that INC was LTD's dependent agent in the United States and that LTD was engaged in a U.S. trade or business through an office or fixed place of business by virtue of INC's U.S. activities. Additionally, the Tax Court found that LTD could not avail itself the securities trading safe harbors set out in Code section 864(b)(2). Consequently, income derived by LTD's U.S. trade or business was taxable and LTD was required to file U.S. returns. The Court also found that LTD was not entitled to deduct expenses or to a correlative adjustment for income allocated to INC as a result of the Tax Court's transfer pricing analysis because LTD had failed to file U.S. returns. InverWorld is one of the few cases discussing when the activities of an agent conducted through that agent's U.S. office or fixed place of business will constitute a U.S. trade or business of the foreign principal. InverWorld is the first case that discusses the securities trading safe harbor set out in 864(b)(2)(i), as applied to dealers and one of the few cases that discusses the securities trading safe harbor set out in 864(b)(2)(ii), as applied to trading for the taxpayer's own account. Petitioners' appeals are pending in both the 5th Circuit (Docket No. 98-60376) and in the D.C. Circuit (Docket Nos. 98-1257 and 98-1258).

Kaps Warehouse, Inc. v. Commissioner, T.C. Memo 1997-309

The taxpayer sold automotive parts and supplies to both related and unrelated customers at the same price, but gave "rebates" at year end to its related customers. The Tax Court found that, by granting the rebates, the taxpayer essentially sold merchandise at non-arm's-length prices and arbitrarily shifted income to related entities. As a result, the Service's reallocation of income to the taxpayer under section 482 was proper.

Kenco Restaurants, Inc. v. Commissioner, T.C. Memo 1998-342, appeal docketed in 6th Cir.

The taxpayers were related corporations, each of which owned or operated one or more Taco Bell restaurants. Each also paid fees to a related corporation, BKK Management, Inc. (BKK), for management and administrative support services. The Service reallocated the BKK fees based on gross sales of the restaurants, with certain adjustments. At trial, the Service offered the testimony of an expert witness who arrived at an allocation which differed from that of the statutory notice. The Service explicitly stated, however, that it had not abandoned the notice. The taxpayers focused their attention at trial and on brief to attacking the allocation advanced by the Service's expert. The court found that the taxpayers had failed to carry their burden of proving that the Service had abused its discretion, i.e., that the allocations in the statutory notice were arbitrary, capricious or unreasonable.

Medieval Attractions N.V. v. Commissioner, T.C. Memo. 1996-455

National Semiconductor Corp. v. Commissioner, T.C. Memo 1994-195

The case involved round trip transfers of silicon chips and technology to further process them between a U.S. company and its S.E. Asian subs, with the U.S. distributor claiming losses on the resale of the imported items. The Tax Court upheld approximately 50% of the section 482 adjustments taken to trial, relying on the Service's expert (with modifications).

Perkin-Elmer Corp. v. Commissioner, T.C. Memo 1993-414

The case involved section 482 adjustments concerning transfers of tangible and intangible property between the taxpayer and its § 936 subsidiary. The Tax Court rejected taxpayer's application of the resale price method, but sustained other features of its computation to arrive at a result that was about equally favorable to both parties.

Pikeville Coal Co. v. United States, 37 Fed. Cl. 304 (1997)

Taxpayer is a wholly-owned, second-tier U.S. subsidiary of a Canadian corporation and owns and operates a coal producing property in Kentucky. The Service examined the price at which the taxpayer sold coal to its parent, and under the authority of section 482, allocated income from the taxpayer to its parent, reducing taxpayer's taxable income. Taxpayer filed a claim, and later a suit for refund, seeking a greater he reduction in its sale price than that allowed by the Service. The IRS moved to dismiss the complaint for failure to state a claim on which relief may be granted, arguing that in effect taxpayer sought an order requiring the Service to apply section 482. With an exception not applicable here, section 482 has traditionally been available to taxpayers for a defensive use only, not, as in this case, offensively. The Court of Federal Claims denied the government's motion to dismiss.

Podd et al. v. Commissioner, T.C. Memo 1998-231 (1998), on reconsideration, T.C. Memo. 1998-418.

Powertex, a U.S. corporation, is closely held by three Canadian citizens, a father and his two sons. Powertex manufactures bulk shipping container liners pursuant to patents held by the individual shareholders. The Service disallowed royalty payments to the individuals on the basis that (1) the patents were worthless, (2) Powertex either owned the patents or held "shop rights" to the patents as a result of paying the expenses of development and registration and furnishing space and equipment to the shareholders who were officers of the corporation and (3) under all circumstances, the amount of royalties being paid was overstated and not arm's length within the meaning of section 482. The Service conceded the first argument that the patents were worthless and the Court completely ignored the second argument that Powertex either owned the patents or held "shop rights". The Court then held under section 482 that the royalties were excessive to the extent that they exceeded 9%.

With respect to other subsidiary issues, the court held that the excessive royalty payments were dividends to the shareholders, that payments to a third party were kickbacks and therefore not ordinary and necessary business expenses, that amounts paid to a Canadian corporation wholly owned by Powertex's shareholders were paid for management services and did not constitute dividends to the individuals, that one of the sons was a U.S. resident for tax purposes and that none of the deficiencies were subject to penalties because the taxpayers had relied on a tax professional.

Seagate Technology, Inc. v. Commissioner, 102 T.C. 149 (1994)

W.L. Gore Inc. v. Commissioner, T.C. Memo. 1995-96.

The Tax Court rejected the taxpayer's motion for summary judgment attacking the Service's application of section 482 to shareholder with less than a majority interest. The taxpayer contended that the Service is precluded from treating the intercompany transfers between petitioner and JGT as "controlled" transactions because petitioner directly owned only 50% interest in JGT, and its indirect ownership of the balance of JGT could not be attributed to petitioner because the attribution rules under section 318 were not expressly made applicable to section 482. The Court held that the question of common control was an issue of fact requiring examination of all relevant indicia of control, including ownership, both direct and indirect, regardless of the applicability of the attribution rules of ownership under section 318

APPENDIX I
Costs of Section 482 Litigation

Tables 1 and 2 show actual costs incurred by the Office of Chief Counsel in preparing and litigating two recent section 482 cases.

Table 1 – Large Case A

TOTAL LABOR		$2,365,854
NON-LABOR DIRECT COSTS		
Expert Witness Fees	$2,103,800	
Other Non-Labor Direct costs[32]	154,707	
TOTAL DIRECT NON-LABOR COSTS		$2,258,507
TOTAL COSTS[33]		$4,624,361

Table 2 – Large Case B

TOTAL LABOR		$1,335,475
NON-LABOR DIRECT COSTS		
Expert Witness Fees	$ 674,000	
Other Non-Labor Direct costs[34]	$ 87,329	
TOTAL DIRECT NON-LABOR COSTS		$ 761,329
TOTAL COSTS[35]		$2,096,804

[32] Includes transcript fees, automated legal research and travel.

[33] Does not include indirect costs such as rent, equipment, services, data processing, or telecommunications, which were estimated to total $549,209.

[34] Includes transcript fees, automated legal research and travel

[35] Does not include indirect costs such as rent, equipment, services, data processing, or telecommunications, which were estimated to total $310,017.

APPENDIX J
APA Costs – FY 1997 Costing Study

Category	Average Cost
Original Requests from Companies Over $1B	$72,268
Renewal Requests from Companies Over $1B	$24,172
Original Requests from Companies Between $100M and $1B	$49,745
Original Requests from Companies Under $100M	$69,957
Small Transaction Request from Company Under $100M	$2,452

Source: 1997 Costing Study

The APA costing study was performed to determine the actual costs incurred to the government of each of the 28 APA cases that closed in FY 1997. The current APA pricing structure contains 12 fee areas; cases which closed in 1997 fell under only five of the 12.

The basis of the costing formula is time. Hours spent on each case are sorted by professional categories. Each category has an average hourly rate which covers salary and benefits for those employees. Multiplying hours by salary rate provides the professional salary and benefits costs associated with each case. Hours are also used to apportion support and management costs, as well as non-labor costs such as rent and computer equipment.

APPENDIX K
Large Case Procedures

Internal Revenue Manual, Part XXXV, Chief Counsel Directives Manual
Chapter (35)300, Coordination
Section (35)3(19)0, Large Case Coordination Procedures

Sub-Section (35)3(19)1, Background and Overview
Date document last amended: 7-13-1995.

Background and Overview

(1) *Introduction.* The large case program is an aspect of tax administration of critical importance to the Internal Revenue Service. In support of this program, the Office of Chief Counsel plays an essential role in assisting in the proper development and disposition of large cases prior to litigation, as well as in litigating these cases before the Tax Court. In recognition of the unique challenges of this program, it is the policy of the Office of Chief Counsel to utilize a coordinated approach to deal with the most significant large case matters, and in appropriate cases, to utilize litigation teams composed of Field and National Office attorneys. This approach is designed to ensure that the best resources of the Office as a whole will be available to deal with those cases that have the greatest importance to tax administration.

(2) *Essential Elements of Large Case Litigation.* Certain aspects of the coordinated and team approach to large case litigation have been used successfully on an *ad hoc* basis in specific cases over the years. Extrapolating from this experience, the procedures in this section focus on two elements that are essential to successful large case litigation:

(a) First, there must be an active working partnership between the National Office and the Field Offices. This partnership must span the entire process of large case litigation from initial case planning and development through pretrial practice, trial preparation, trial of the case, and submission of briefs. Every person and every office involved in the case must be encouraged to contribute to the entire process.

(b) Second, senior executives in both the Field and the National Offices must be directly engaged in all significant large cases. Executives will be expected to participate in the development of substantive legal positions, decisions about litigation tactics and strategy, and substantive review of significant written pleadings, motions, and briefs. Their involvement must go well beyond traditional notions of management review and oversight.

(3) *Overview of Procedures.* This section incorporates these basic principles into specific procedures for the coordination and team litigation of large cases.

These procedures do not mandate a set of rules to be rigidly followed in every case. Rather, they establish an overall framework for dealing with all large cases, and within this framework suggest general guidelines for actions in each case.

(a) *Docketed Cases.* This section provides a five step process for handling docketed cases.

1 *Screening*--all cases will be screened to identify the large cases that should be subject to the procedures under the section (Notice Cases) and to determine which of those Notice Cases should be subject to team litigation. Cases not subject to these procedures will be handled through existing procedures.

2 *Work Plan*--an appropriate work plan will be developed for every Notice Case; the precise contents of the work plan will be determined on a case-by-case basis. For example, if case processing is suspended because of the court's consideration of an interlocutory matter, a less detailed work plan may be adequate and longer periods may be provided between updates and reviews of the work plan.

3 *Coordination and Litigation Teams*--there will be close coordination between the Field and the National Office in every Notice Case; formal litigation teams will be established for the most significant Notice Cases. There will be a lead Field attorney and a principal National Office contact attorney for every Notice Case. If two Associate Offices share jurisdiction over an issue or an issue within one office's jurisdiction is intertwined with an issue within the jurisdiction of another office, one principal National office contact will be designated for the case. However, if two or more issues are to be coordinated which are wholly independent and under the jurisdiction of different Associate offices, each Associate Office will designate a principal contact for issues within its jurisdiction. Other attorneys in the Field and National Office will participate in each case to the extent appropriate.

4 *Team Organizational Meeting.* An organizational meeting, telephone conference call, or teleconference among those assigned to the case should take place as soon as practical after the case is designated as a Notice Case. The purpose of holding such a meeting will be to develop the initial work plan, define the roles of, and assign responsibilities to, the participants, and to foster a spirit of cooperation and teamwork. Obviously, agreements as to roles, work plans etc., reached at the meeting are subject to normal executive oversight and approval. In determining roles and assigning tasks, emphasis should be on a team approach.

5 *Post-Review*--there will be a systematic review of the performance of the Office in every Notice Case.

(b) *Nondocketed Cases.* These procedures also cover coordination between the Field and the National Office whenever the Field provides significant legal advice in a nondocketed case.

Sub-Section (35)3(19)2 , Definitions
Date document last amended: 7-13-1995.

Definitions

(1) *Large Case.* In general, the term “large case” means any case described in one or more of the following categories:

(a) The case involves a Coordinated Examination Program (CEP) taxpayer;

(b) The case involves an Industry Specialization Program (ISP) issue;

(c) The case (and all related nonshelter groups of cases) involves a disputed liability totalling $10 million or more (including additions to tax and penalties, but not including interest); or

(d) The case involves an issue of potential significance to tax administration (including all cases assigned to Special Trial Attorneys).

(2) *Certain Large Cases Excluded From Notice Cases*

(a) *Bankruptcy/Insolvency Cases.* Significant bankruptcy/insolvency cases are not treated as large cases subject to the procedures in this section and will be handled in accordance with CCDM (34)(10)30.

(b) *Refund Cases.* Refund cases arising in either the U.S. Court of Federal Claims or the U.S. District Courts are not subject to these procedures; however, the office will provide assistance and support to the Department of Justice in these cases in accordance with established procedures.

(c) *Discretion to Exclude Cases.* A case that otherwise meets the definition of a large case may be excluded from the procedures described in this section as a result of the screening process described in (35)3(19)3:(1) below.

(3) *Notice Cases.* The term “Notice Case” as used in this section means those cases that are designated by the procedures described in this section as subject to either coordination or team litigation provisions.

(4) *Team Litigation.* The term “team litigation” as used in this section refers to the process that will be employed in those Notice Cases that are determined to be so significant as to warrant the formal establishment of trial litigation teams composed of National Office and Field attorneys. Teamwork and appropriate

coordination between the National Office and the Field is, of course, expected and encouraged in every Notice Case, including those not selected for formal team litigation.

Sub-Section (35)3(19)3 , Cases in Docketed Status
Date document last amended: 1-6-1997.

Cases in Docketed Status

(1) *Screening of Petitions.* Tax Court petitions (including amended petitions) will be screened in both the National Office and the Field. The purpose of this screening is to determine which petitions represent large cases as defined in (35)3(19)2, and which of these large cases should be excluded from the procedures of this section because the issues in the case either: (a) involve well-settled principles of law; or (b) are not sufficiently complex or important to warrant the special commitment of resources envisioned by this section. Any case excluded from the procedures in this section will be handled under existing coordination procedures.

(a) *National Office Screening and Report to the Field.* The National Office will be responsible for screening all petitions with proposed deficiencies in excess of $1,000,000, other than cases in which the deficiency is in Estate and Gift tax or the deficiency is based upon transferee liability.

1 The Assistant Chief Counsel (Field Service) will identify and provide copies of all such petitions to the National Office function(s) responsible for screening and to the Special Counsel (Modernization and Strategic Planning) ["(MSP)"] within 5 days of the date the petition is served on the National Office.

2 Petitions will be screened by each Associate Chief Counsel Office with subject matter jurisdiction over the issues presented in the case. Petitions will be screened by both the Field Service function and the Technical function within each Associate Office.

a For each petition screened--the Associate Office shall determine whether the case (a) should be classified as a Notice Case or (b) should be excluded from the procedures in this section (either (1) because it does not meet the definition of a large case stated in (35)3(19)2, or (2) because it is properly excludible from the procedures in this section under the criteria stated in (35)3(19)3:(1)) or (c) should be temporarily deferred for a period of no more than 30 days (as provided in subparagraph d below).

b For each proposed Notice Case--the Associate Office shall designate a principal National Office attorney for the issues under the jurisdiction of that Associate Office (generally at grade GS/GM 15), and shall determine whether the Associate believes the case should also be classified as a team litigation case.

c Within 5 business days after a determination that a case should be classified as a Notice Case, the Associate Office shall so notify the Field Office to which the case is assigned, the appropriate Regional Office, the Assistant Chief Counsel (Field Service), and the Special Counsel (MSP). *See* initial communication procedures, (35)3(19)3:(1)(d).

d If the Associate Office believes that the petition cannot adequately be screened because of an inadequate description or explanation of the issues involved, the Associate Office will contact the Field attorney to determine whether the Service files can provide information to determine the significance of the issues. If the significance cannot be determined within the initial screening period, by agreement of the Associate Office and the Field, screening may be deferred for a period not exceeding 30 days. This period of time may not be further extended. The case shall temporarily be classified as “deferred” for the monthly report provided below. The case will then be screened again in the following month, with the benefit of greater knowledge of the significance of the issue, and a determination made whether the case should be classified as a Notice Case.

e Within 10 days after the end of each month, each Associate Office shall provide to the Assistant Chief Counsel (Field Service), a list of all petitions assigned to that Associate Office for screening during the month, and the proposed classification of each case.

3 The Assistant Chief Counsel (Field Service) will prepare a monthly report reflecting the results of the National Office screening. This report will compile the information provided by the respective Associate Offices with respect to the petitions assigned to them for screening during the previous month. This report will be distributed to the Chief Counsel and Deputy Chief Counsel, all Regional Counsel, Deputy Regional Counsel (Tax Litigation), Assistant Regional Counsel (Large Case), all Associate Chief Counsel, all Assistant Chief Counsel, and the Special Counsel (MSP), no later than 15 days following the close of the month during which the listed petitions were served on the National Office.

(b) *Field Screening and Response to National Office.* To the extent not otherwise specified in this section, screening of cases by the Field will be done in accordance with procedures established by the Regional Counsel.

1 Every petition will be screened by the assigned District Office or Office of Assistant Regional Counsel (Large Case). Within 5 business days after a petition is screened, the assigned Office will notify the Regional Office of every

case it recommends be treated as a Notice Case or whether it recommends that classification be deferred for a period not exceeding 30 days.

2 Within 5 business days after it determines that a case identified by an assigned Office should be classified as a Notice Case, the Regional Office will so notify the Assistant Chief Counsel (Field Service). At that time, the Regional Office will also indicate whether it recommends the case be subject to team litigation, and provide the name of the lead Field attorney for the case. The Assistant Chief Counsel (Field Service) will provide this information to the appropriate Associate Chief Counsel and to the Special Counsel (MSP).

3 If the Regional Office believes that the petition cannot adequately be screened because of an inadequate description or explanation of the issues involved, the Regional Office will contact the Associate Office. If the significance of the issue cannot be determined within the initial screening period, by agreement of the Associate Office and the Regional Office, screening may be deferred for a period not exceeding 30 days. The case will then be screened again in the following month, with the benefit of greater knowledge of the significance of the issue, and a determination made whether the case should be classified as a Notice Case.

4 Within 10 days after receipt of the National Office report listing the cases screened in the National Office during the previous month, the Regional Office will advise the Assistant Chief Counsel (Field Service) of any disagreement with any item in the report, of any additional cases or information that should be included in the report, and of any cases that the Field believes cannot be properly evaluated pending receipt of the administrative file.

(c) *Reconciliation of National Office and Field Classification of Cases.* The Assistant Chief Counsel (Field Service) will coordinate the responses received from the Regional Offices with the appropriate Associate Chief Counsel, and will circulate a monthly cumulative report of Notice Cases.

1 Final decisions as to whether a case will be treated as a Notice Case, and whether team litigation procedures will be employed for such cases, will be made by the Regional Counsel and the affected Associate Chief Counsel. Absent agreement, a case will betreated as a Notice Case if either the Regional Counsel or the Associate Chief Counsel requests such treatment. Any disagreement as to whether a Notice Case will be subject to team litigation will be resolved by the Chief Counsel or Deputy Chief Counsel.

2 A case that is initially excluded from the procedures of this section, or initially determined not to require team litigation, may later be reclassified as a Notice Case or made subject to team litigation procedures if, as the case progresses, it is determined (in accordance with the procedures used for the initial classification) that such reclassification is appropriate. Likewise, a case

initially classified as a Notice Case, or initially made subject to team litigation, may subsequently be excluded upon agreement of the Regional Counsel and Associate Chief Counsel.

(d) *Initial Communication Following Screening.* As soon as practical after a case is identified as a proposed Notice Case, the lead Field attorney and the principal National Office attorney should communicate with each other to discuss the issues in the case and the proposed Answer. This initial communication should not wait for the distribution and reconciliation of the monthly reports described in (35)3(19)3:(1)(a)3 and (35)3(19)3:(1)(b)3, but rather should be initiated as soon as either the lead field attorney or the principal National Office attorney is assigned to the case. To facilitate this initial communication--

1 If the principal National Office attorney is assigned to a proposed Notice Case before a lead Field attorney is assigned to that case, he/she should contact the Assistant Regional Counsel (Large Case).

2 If the lead Field attorney is assigned to a proposed Notice Case before a principal National Office attorney is assigned to that case, he/she should contact the Assistant Chief Counsel (Field Service).

(2) *Work Plan.* A work plan is essential to the proper development, trial and briefing of every Notice Case. The specific form and contents of the work plan will be determined by the responsible executives on a case-by-case basis, according to the nature, importance and difficulty of the legal and factual issues presented by the case, whether the case requires team litigation, the activity or status of the case, and the availability of resources. The following guidelines are intended to facilitate the creation of appropriate work plans.

(a) *Contents of Work Plan.* A complete work plan will set forth the essential facts, legal issues, litigation strategy, and time tables that are expected to apply to the case. It is expected that the work plan will become more specific and fully developed as the case progresses. The work plan will be prepared using the FALCON Report program. Details of the format and content of the work plan are set forth in Exhibit (35)300-13. In general, a complete work plan should:

1 Indicate whether the case is to be referred to Appeals (in whole or in part) for consideration or retained by Counsel or returned from Appeals, if appropriate, for factual development, pursuant to existing procedures, and provide a schedule for monitoring the progress of the case (or part thereof) while it is with Appeals to ensure adequate time for development of any issue that is not resolved by agreement.

2 Describe further action needed to properly develop the legal and factual issue(s) presented by the case. Depending on the case, the required actions

may include clarification of office position on legal issues, retention of expert witnesses, determination of the need for discovery, etc.

3 Establish an overall schedule for the case, including a schedule for completion of the actions noted in subparagraph (2)(a)2, as well as the ordinary landmarks of litigation (e.g., stipulations of fact, trial memorandum, trial, briefing, etc.).

4 Identify the responsibilities of each Field and National Office attorney assigned to the case. Because the role of each participant will vary depending on the particulars of each case, the work plan should set forth the specific tasks and projected completion dates for each participant to avoid misunderstandings and disagreements.

(b) *Initial Preparation and Approval of Work Plan.* The lead Field attorney will be responsible for preparation of the work plan, in coordination with the principal National Office attorney. The plan will be submitted for review to the Regional Counsel, appropriate Associate Chief Counsel, and the Special Counsel (MSP), within 60 days after filing the Answer. Within 30 days thereafter, the Regional Counsel and Associate Chief Counsel will agree on an approved work plan. The Assistant Regional Counsel (Large Case), will be the contact person regarding processing of work plans within the region whether or not the lead Field attorney is a Special Trial Attorney and whether or not the region has processed the work plan in another manner. A copy of the approved work plan will be provided to the affected Field and National Office attorneys and to the Special Counsel (MSP).

(c) *Updating and Review of Work Plan.* The work plan will be updated as necessary to reflect actual and anticipated developments in the case, and will generally be formally reviewed and approved at least semi-annually (based on the date of the initial work plan) by the Regional Counsel and Associate Chief Counsel(s). Copies of reviewed work plans will be provided to the Special Counsel (MSP) and the Deputy Chief Counsel, and the original forwarded to the Assistant Chief Counsel (Field Service) for retention. For this section, “updating” means the modification of the work plan to reflect events and necessary adjustments, and regularly updated work plans are used routinely by the team and local managers as a tool in day to day development of the case. “Review” of an updated work plan encompasses executive oversight of the work plan at the regional and national office levels. No updating or review of a work plan is required during the period of time that the case is submitted to a court (the Tax Court or appellate court) and is pending a decision of that court. Upon a decision or opinion of the court, a work plan will be required to provide for further case processing.

(3) *Litigation Teams.* National Office and Field attorneys are expected to share responsibility in all aspects of case development, trial, and briefing. The nature and degree of responsibility assigned to individual attorneys will vary from case to

case, based on the nature, importance, and difficulty of the legal and factual issues presented by the case and the availability of resources. An organizational meeting, teleconference, or videoconference among those assigned to the case should be held as soon as practical after the case is designated as a Notice Case to develop the initial work plan, define roles, assign responsibilities, and encourage teamwork. The following general guidelines will apply unless the work plan provides otherwise:

(a) *Lead Field Attorney.* The Lead Field attorney will be the counsel of record, will be responsible for overall litigation of the case, and will be responsible for preparation of all written submissions (stipulations of fact, trial memoranda, briefs, etc.), in consultation with the other team members.

(b) *Principal National Office Attorney.* The principal National Office attorney(s) will be responsible for coordinating National Office participation in the case and will be expected to become knowledgeable about the case as a whole. To the extent provided in the work plan, she/he will assist in the preparation of all written submissions, including preparation of initial drafts, and will otherwise participate in the trial of the case.

(c) *Other Attorneys.* Other attorneys from the Field or National Office assigned to a trial team will participate in the case to the extent provided in the work plan.

(4) *Formal advice from National Office.* Formal Field Service Advice should be requested concerning any aspect of a Notice Case (including technical, procedural, or litigation questions) whenever such advice may be helpful in the development of the case. The Assistant Chief Counsel with jurisdiction over the issue must review and approve any responsive Field Service Advice.

(5) *Post-Review of Cases.* There will be an analysis of the performance of the Office of Chief Counsel in every Notice Case. This analysis is designed primarily to facilitate sharing useful experiences, information, and innovations throughout the Office, to identify and correct systemic problems, and to gather data that will contribute to improved tax administration. It is not intended to focus on the performance of the individuals involved in particular cases.

(a) *Report on Notice Case Issue Results.* A report, “Notice Case Issue Results”, will be prepared in the form of Exhibit 35(300)17 within 60 days of the date of any of the following events:

1 Settled issues: the earlier of the filing of the decision document or a stipulation of settled issues covering the Notice issue.

2 Excluded issues (issues for which Notice Case designation is removed): upon agreement of the responsible Regional Counsel and Associate Chief Counsel pursuant to CCDM (35)3(19)3(1)(c)2.

3 Tried issues (including dispositive motions) not appealed: the conclusion of the 90 day appeal period following entry of the Tax Court decision.

4 Appealed issues (interim report): when the national office advises that a notice of appeal has been filed.

5 Appealed issues (final report): when the Tax Court decision becomes final.

(b) *Preparation, Review and Approval.* The lead trial attorney will prepare the report on Notice Case Issue Results for events 1 to 4.

1 The report for events will be prepared by the national office attorney assigned to the issue on appeal, except that, if the issue is remanded and not appealed after remand, the report for event 5 will be prepared by the lead trial attorney.

2 Reports will be reviewed and approved by the responsible Assistant Regional Counsel (Large Case) and the Assistant Chief Counsel. Copies of approved reports will be provided to the Deputy Chief Counsel, the Special Counsel (M&SP), and the Assistant Chief Counsel (Field Service). Upon receipt of an approved report for events 1, 2, 3 or 5, the Assistant Chief Counsel (Field Service) will remove the issue from the Monthly Large Case Report.

(c) To aid in the post-review of settled Notice Cases, the Lead Field Attorney will be responsible for submitting complete copies of the Appeals supporting statement or the counsel settlement memorandum to both the Special Counsel (MSP) and to the Deputy Associate Chief Counsel (Domestic Field Service) within thirty days after the decision is entered.

Sub-Section (35)3(19)4 , Field Assistance in Nondocketed Large Cases
Date document last amended: 7-13-1995.

Field Assistance in Nondocketed Large Cases

(1) *Purpose.* To ensure consistency of legal advice provided by the Office, to promote the best possible development of large cases, and to keep the National office apprised of emerging issues raised by large case taxpayers, Field attorneys providing assistance to Examination or Appeals in nondocketed large cases will coordinate all significant advice with the National Office.

(2) *Definition of Significant Advice.* For purposes of this procedure, legal advice is deemed significant if it is material to the development or disposition of any issue in the case, except as provided below.

(a) Legal advice generally will be deemed not significant if it is consistent with advice previously rendered by the National Office in the same case.

(b) Legal advice may be deemed significant even if procedural in nature; however, advice is not deemed significant if it deals with routine factual development (such as documents that need to be obtained, problems with IDRs, summonses, etc.).

(c) In the interest of keeping the National Office fully advised, advice should be presumed significant unless the Field attorney is reasonably certain that it is not.

(3) *Coordination Prior to Providing Significant Advice.* In general, Field attorneys should use established procedures for requesting Technical Advice, Technical Assistance, or Field Service Advice from the National Office before providing significant legal advice to Examination or Appeals in any nondocketed large case. Such procedures must be used whenever the advice involves a legal issue that cannot be resolved with a high degree of certainty by application of settled principles of law to the particular facts of the case in which the advice is requested.

(4) *Coordination After Providing Significant Advice.* Field attorneys may provide significant legal advice to Examination or Appeals in a nondocketed large case without prior coordination with the National Office only if: (a) the advice involves the application of well-settled principles of law to the facts of a particular case, or (b) the circumstances in which the advice is requested make prior National Office coordination impractical. After providing such advice, the Field attorney must coordinate with the National Office as described below.

(a) *Information Copy Sent to National Office.* A copy of the advice will be forwarded to the Assistant Chief Counsel (Field Service) within 10 days of the advice being rendered. If the advice is given orally, a written summary of the advice will be prepared with copies forwarded to the Assistant Chief Counsel (Field Service) and the regional office within such 10 day period. The Assistant Chief Counsel (Field Service) will provide copies of all such advice to the appropriate Associate Chief Counsel and the Special Counsel (MSP).

(b) *Response of National Office to the Field.* No later than 10 days after receipt of the copy of the Field advice, the Associate Chief Counsel will respond directly to the Field and will provide a copy of the response to the Assistant Chief Counsel (Field Service) and to the Special Counsel (MSP). The response will indicate whether the National Office: 1) concurs with the Field advice; 2) believes some modification of the advice is appropriate; or 3) needs additional information or time for analysis in order to evaluate the advice. In the event that the National Office cannot provide a definitive response to the Field within this 10 day period, the Associate Chief Counsel will advise the Field when a response will be provided.

(c) *Report of Advice Received and Responses Provided.* The Assistant Chief Counsel (Field Service) will maintain a list of all reports of advice received from the Field and of the responses to such advice provided by the respective Associate Chief Counsel. This list will be circulated to the Chief Counsel, Deputy Chief Counsel, Regional Counsel, Deputy Regional Counsel (Tax Litigation), Assistant Regional Counsel (Large Case), Associate Chief Counsel, Assistant Chief Counsel, and the Special Counsel (MSP), no later than 15 days following the close of the month during which the listed items were received in the National Office.

Sub-Section (35)3(19)5 , Provisions Applicable to All Cases
Date document last amended: 7-13-1995.

Provisions Applicable to All Cases

(1) *Management Responsibility.* The procedures of this section do not modify existing management responsibility for supervision of attorneys or for determining work priorities and scheduling. It is the responsibility of the managers of every attorney involved in a large case to remain appropriately informed of developments in the case.

(2) *Delegation of Authority.*

(a) *Regional Counsel.* Except as provided below, the authority of a Regional Counsel under this section may be delegated only to a Deputy Regional Counsel (Tax Litigation) or to an Assistant Regional Counsel (Large Case).

(b) *Associate Chief Counsel.* Except as provided below, the authority of an Associate Chief Counsel under this section may be delegated only to a Deputy Associate Chief Counsel or an Assistant Chief Counsel.

(c) *Screening of Petitions.* Authority to screen petitions under this section may be delegated to employees at level GM/GS 15 or above; however, authority to exclude a large case under the criteria specified in (35)3(19)3:(1) or to determine that a case should be subject to team litigation, may not be so delegated.

(d) *Review of Certain Work Plans.* Authority to preliminarily review and approve on behalf of the Field the work plan for any case in which the Lead Field Attorney reports to a District Counsel may be delegated to that District Counsel. However, all work plans will be coordinated by the regions with the Assistant Regional Counsel (Large Case), who will be responsible as the regional contact on that work plan.

(e) *Post-Review of Advice Provided by Field.* Authority to approve the National Office response to the Field pursuant to (35)3(19)4:(4)(b) involving post-review of significant legal advice provided by the Field may be delegated to those persons in the National Office with authority to approve Technical Advice Memoranda or Field Service Advice.

(3) *Reconciliation of Disagreements.* Any disagreements concerning the application of these procedures will be resolved by the Regional Counsel and Associate Chief Counsel, or if they cannot agree, by the Chief Counsel or Deputy Chief Counsel.

(4) *Coordination Through Field Service.* In general, information or written material required to be submitted from the Field to the National Office will be submitted to the Assistant Chief Counsel (Field Service), who will forward such information or material to the affected Associate Chief Counsel and Special Counsel (MSP) within 2 days of its receipt in the National Office. The Field may, however, provide information or material directly to the affected Associate Chief Counsel, in which case such Associate Chief Counsel will provide copies to the Assistant Chief Counsel (Field Service) within 2 days of the material being received in the National Office.

(5) *Role of Special Counsel (MSP)*. These procedures do not modify the role of the Special Counsel (MSP) as the successor to the Special Counsel (Large Case) as a program manager charged with monitoring and coordinating current activities, and designing strategic goals and plans for better identifying and litigating large cases and large case issues, as set forth in Chief Counsel Notice N(30)000-191, April 18, 1991. On January 15, 1995, the duties of the Special Counsel (Large Case) were assumed by the Special Counsel (Modernization and Strategic Planning).

(6) *Role of Appeals in Notice Cases.* These procedures do not modify the role of Appeals in docketed cases. However, because of the importance of the case, how, when, and under what terms, the case or issues therein are referred to Appeals should be a conscious decision of both Counsel and Appeals. Appeals and Counsel shall work cooperatively together, understanding that it is Counsel's role to try the case, and Appeals' role to make an independent effort to settle the case.

(a) The roles of, procedures, and the relationship between Counsel and Appeals are set forth in Rev. Proc 87-24 [to be updated in 1995] and Proc. Reg. §601.106 [as finally amended in 1995]. The selection of a case to be a Notice Case does *not*, in itself, constitute a "designation for litigation" under the procedures of (35)3(14)0.

(b) In general, Appeals will have exclusive jurisdiction over a Notice Case once it has been referred to Appeals by Counsel.

(c) Upon the case becoming at issue, Counsel and Appeals shall examine the case to determine whether the case (or specific issues) should be considered by Appeals immediately or whether that consideration should be delayed (whether or not the case has already been transferred to appeals for consideration). Deferral of Appeals consideration may be appropriate when:

1 A recommendation is made to designate an issue for litigation under the procedures of (35)3(14)0.

2 An issue before the court is so insufficiently factually developed that a fair and objective determination of the litigation hazards cannot be made. In this event, field counsel will immediately begin discovery on that issue to develop it. The work plan shall set reasonable limits on the time for development and the referral to Appeals.

(d) Rev. Proc. 87-24, Sec. 1.06, provides that in appropriate cases, such as those involving significant issues or large deficiencies, Counsel and Appeals may work together on a case. When this is done, Appeals has settlement jurisdiction and Counsel acts in an advisory role.

(e) The taxpayer, through counsel, should be advised of Appeals' settlement role in the case or that the case has been referred to Appeals generally.

(7) *Application to Pending Cases.* These procedures will be applied to all cases docketed on or after June 1, 1995, and to pending cases docketed to June 1, 1995, to the extent practical based on consultations between the appropriate Field and National Office managers.

Sub-Section (35)3(19)6 , Review of AIR Agreements

Date document last amended: 7-13-1995.

[omitted]