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SECTION 482 AND ITS EFFECTS ON INTERNATIONAL BUSINESS TRANSACTIONS

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Thank you, Mr. Fisher, and good morning ladies and gentlemen. It is a real pleasure to be with you this morning and I would like to convey the apologies of Jesse Miles who had planned to be with you, but unfortunately is unable to be here because of a very bad case of laryngitis which he developed yesterday. I am most happy to be able to take his place.

The subject that I will cover with you today has been changed to some degree from that which appears on the program—"Significant Tax Accounting Developments Under Section 482." When the program for the meeting was originally discussed with Professor Atkeson, it was anticipated that final regulations under Section 482 would be issued prior to this meeting since, as you know, the proposed regulations under Section 482 were issued in August of 1966. In fact, however, the final Section 482 regulations have still not been issued, although in a recent speech to the National Foreign Trade Council Assistant Secretary of the Treasury Stanley S. Surrey indicated that final regulations are expected to be issued within the next few months.

Therefore, the approach that was anticipated for my talk this morning is really not available, and rather than discussing the few cases in this area that have been litigated this past year, I feel it would be more useful to discuss Section 482 in general terms, its background, and certain comments that I have concerning the proposed regulations.

Developments prior to issuance of proposed Section 482 Regulations

As most of you know, Section 482 of the 1954 Code is a successor to Section 45 of the 1939 Code. Section 482 is only one sentence long, but this single sentence is one of the most important provisions of the United States income tax law affecting international business transactions. I would like to read this one sentence to you to indicate the scope of authority that the section gives to the Treasury:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary

or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”

Up until 1961 the Internal Revenue Service's record of winning cases under this section was not very impressive. Representatives of the Treasury Department requested that the section be amended by the Revenue Act of 1962, to expand the authority of the Internal Revenue Service, and to provide a formula approach to certain allocations. The House of Representatives honored the request and passed an amendment to Section 482. However, the Senate did not agree, and the Conference Committee Report on the Revenue Act of 1962 noted that “Section 482 already contains broad authority to the Secretary of the Treasury to allocate income and deductions” and it recommended that the Treasury “explore the possibility of promulgating regulations under this authority which would provide additional guidelines and formulae for the allocation of income and deductions in cases involving foreign income.”

Under this rebuff, and softened by the apparent Congressional assurance that the existing Section 482 regulations contain substantial authority, the Internal Revenue Service started to exercise its authority to a much greater extent during the period 1961, 1962, and 1963 than had previously been the case, particularly in respect of international transactions. Numerous substantial deficiencies were asserted and many were based on new and varied theories. The Internal Revenue Service apparently took the view that it would determine what authority it did possess under Section 482 and if taxpayers did not wish to accept the deficiencies, the courts could spell out the scope of the Service's authority. A broad section of the business community involved in international operations became extremely concerned about the situation since many businessmen and tax advisers felt that in certain cases an unreasonable approach was being taken. One of the basic complaints was the contention that the Internal Revenue Service's approach actually represented a retroactive change in the rules under which taxpayers had been operating for years.

In December 1964, the Internal Revenue Service relented to some extent and issued Revenue Procedure 64-54 which acknowledged that Section 482 allocations involving controlled foreign entities could result in undue hardship by causing double taxation to occur. Therefore, in this procedure, the Internal Revenue Service agreed, for taxable years begin-

ning before 1963, not to pursue several types of allocations. The areas in which allocations would not be made, except in certain circumstances, included loans and advances between related companies, the use of intangible property by related entities and certain services performed for related entities. This revenue procedure also provided an offset principle, whereby, if an allocation were made, the U. S. income tax on such allocation could be offset by the foreign income tax imposed on a controlled foreign entity in respect of amounts that were allocated. This procedure was extended in large part by Revenue Procedure 66-33 to cover years beginning prior to 1965. However, it has been indicated by the Treasury that this revenue procedure will not be extended further.

In April 1965, the Internal Revenue Service issued another procedure which recognized the problem of repatriating earnings after a Section 482 allocation has been made (Revenue Procedure 65-17). It allows U. S. taxpayers, in most cases, to collect from a controlled entity the amount allocated under Section 482 without dividend consequence. This is accomplished under the revenue procedure either by considering dividends received in the year of allocation as being tax-free or, to the extent that dividends received in the year of allocation do not cover the amount of allocation, by setting up an account receivable as of the end of the year of allocation which can then be repatriated without U. S. tax being imposed. As in the case of Revenue Procedure 64-54, this procedure also covers years beginning prior to 1965. It should be noted that Revenue Procedure 65-17 may also be used in later years under certain circumstances.

Proposed Section 482 Regulations

With this background in mind, I would now like to turn to a discussion, in very general terms, of the proposed regulations themselves. It is interesting that the present proposed regulations, which were issued in August of 1966, are really the second set of proposed regulations that has been issued. In the spring of 1965, after the above described revenue procedures had been issued, proposed regulations were issued relating to methods of allocations, loans and advances, the performance of services, and the use of tangible property. This first set of regulations then became superseded by newly proposed regulations issued in August 1966 covering and modifying to some extent the areas I have just mentioned and also covering inter-company pricing and the use of intangible property by related taxpayers.

Loans and advances

Now, let us look briefly at certain of the provisions of the proposed regulations starting with loans and advances. The proposed regulations

provide that, when a loan or advance is made by one member to another member of a group of controlled entities, an "arm's-length rate" of interest must be charged on such loan or advance. An "arm's-length rate" for this purpose is the rate which is actually charged or which would have been charged, at the time the indebtedness arose, in independent transactions under similar circumstances.

If the creditor does not regularly lend money to unrelated parties, then the range of rates of interest that will be acceptable is from 4 to 6 percent. However, if no interest is charged, or if the rate charged is not within the 4 to 6 percent range, the IRS will require that an interest charge of 5 percent be reflected. It should be noted that the regulations do allow these creditors to deviate from the above described hard-and-fast percentage rules if the taxpayer can establish to the satisfaction of the District Director of Internal Revenue that another rate of interest is more appropriate. Furthermore, if the loan represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's-length rate shall be the rate actually paid by the lender, unless a more appropriate rate can be established.

The rules relating to imputation of interest apply whether or not the indebtedness is evidenced by a written instrument. In addition, interest can be imputed on transactions arising in the ordinary course of business—e.g., sales, leases, the rendering of services, or the extension of credit. The proposed regulations do offer some relief on ordinary business transactions by providing an exception where indebtedness is outstanding for less than six months (or, in industries where a longer payment period is customary, such longer period). In this case, payments on outstanding indebtedness are to be applied on a first-in/first-out basis.

The only other specific exception to the interest imputation rules arises in circumstances where a parent company intends to make a contribution to the capital of its subsidiary or where a dividend from a subsidiary to its parent is intended. This exception could prove to be an important one in the future. Because of strict foreign capital requirements and/or unstable conditions overseas, it has been quite common in the past for U.S. parent companies to finance their foreign subsidiaries with a relatively minor amount of capital and a substantial amount of indebtedness (so-called "thin capitalization"). The proposed regulations give recognition to this situation and do not require an interest charge if it is shown that the alleged indebtedness really was intended to be permanent capital. Obviously, treating the indebtedness as capital may cause repayment of the so-called indebtedness to be treated as a dividend, and it therefore may be difficult to repatriate funds to the United States without incurring U. S. tax. As to loans or long-standing

receivables in the other direction, where a subsidiary is a creditor of its parent, the interest imputation rules will similarly not apply if it is shown that these amounts really constitute a dividend distribution since there was actually no real intention to repay the balances.

Performance of services

Under the proposed regulations relating to the performance of services, the District Director of Internal Revenue is given the authority to allocate costs or deductions between members of a group of controlled entities to properly reflect the performance of managerial, administrative, technical, or other services by one member for another if proper reimbursement for the services performed has not been made. Generally, the determining factor in deciding whether an allocation is called for is the benefit intended from the performance of services. If the performance of services was intended to benefit a single member of the group, or if the services were undertaken for the joint benefit of all members of the group, the regulations require an allocation among the affected members. Furthermore, an allocation is authorized even if the anticipated benefits are not realized.

There are two specific situations involving the performance of services that do not require an allocation:

1. If the probable benefits to the other members of the group are so indirect or remote as to be negligible.
2. If the service performed is merely a duplication of a service which the related party has independently performed or is performing for itself. Although these two exceptions would appear at first glance to have wide-sweeping application, the examples in the regulations indicate an intention to view them somewhat narrowly.

The regulations in their present form adopt a "full cost theory" of allocation. Thus, for example, if a computer is used for the joint benefit of the taxpayer and other members of a controlled group of companies, the proposed regulations indicate that an allocation should normally be made of the full cost of operating the computer even if the additional use of the computer for the benefit of the other members did not increase the cost to the taxpayer. It should be noted, however, that Secretary Surrey has indicated in his recent speech to the National Foreign Trade Council that, in response to comments that the Treasury has received from the business community, further consideration has been given to the "full cost" theory and we may expect some modifications in the final regulations to provide alternatives which may be more appropriate in a given situation.

Use of tangible property

The third area covered by the proposed regulations relates to one member of a group of controlled entities using property owned by another member of the group. The regulations state that if an arm's-length charge is not made for the use of tangible property, the District Director of Internal Revenue may allocate income to the owner to properly reflect such arm's-length charge.

An arm's-length rental charge is considered to be the amount that would have been charged if unrelated parties were involved. The allocation will represent the sum of the following items, unless the taxpayer can demonstrate that a different amount would be more appropriate:

1. The amount of depreciation allowable on the property. (A de minimis rule is provided to cover property that has already been subject to a substantial amount of depreciation by the owner, so that at least some depreciation is computed.)
2. Expenses of the owner which directly or indirectly relate to the property.
3. Five percent of the adjusted basis of the property. (This is the profit factor.)

Use of intangible property

With respect to the transfer or use of intangible property, the proposed regulations require, as in the case of the other sections of the regulations, an arm's-length charge for intangible property used by a related party. The District Director is authorized to make allocations with respect to transfers of intangibles between related parties where an arm's-length charge has not been made. The standards to be applied in determining the amount and form of allocation are the amount and type of payment (i.e., royalty, lump-sum payment, etc.) that would have been agreed upon by unrelated parties under similar circumstances.

One of the points of particular interest with respect to this part of the proposed regulations is the type of intangible property which is listed in the regulations as requiring a charge. It is certainly no surprise that the proposed regulations include patents, copyrights, trade marks and trade names among the items defined as intangible assets. However, the definition is further extended to include methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data and other similar items. It seems clear that few taxpayers in the past considered certain of these last-named items as intangible assets requiring a charge.

In lieu of requiring an actual charge for the use of intangibles, the

proposed regulations provide that the District Director will generally not make allocations in cases in which a member of a group of controlled foreign entities acquires an interest in tangible property as a participating party in a bona fide cost-sharing arrangement for the development of intangible property. The acquisition of the intangible property will not be considered to be a transfer. The regulations require that these cost-sharing arrangements be reduced to writing. If the arrangement was in existence, in either oral or written form, prior to the date these regulations are finalized, the arrangement must be conformed to the requirements of the regulations and be in written form in order to be recognized by the District Director for periods subsequent to the issuance of final regulations.

The type of arrangement contemplated by this paragraph of the regulations is one in which the parties bear their full share of the costs and risks of the project, such share being equal to that which an unrelated party would have borne to acquire the same interest in the same property under similar circumstances.

A number of factors must be considered in determining the costs and risks required to be shared and measuring each participating member's full share of the costs and risks of developing the intangible property. These factors include the following:

1. To the extent that previously developed intangible property is made available to the group by one of the parties to the arrangement, all of the parties are required to bear their share of the value of the use of such previously developed intangible.

2. The risk contemplated by the regulations refers to the possibility that no intangible property will be produced or the value of the intangible property will not be sufficient to allow the participating members to recover their costs.

3. To the extent that an arrangement is considered to be a bona fide cost-sharing arrangement, the District Director still retains the right to make an allocation to the extent that it is determined that each of the participating members has not reflected his "correct" full share of the costs and risks of the project.

In my opinion, the requirement to value prior intangibles will present a major practical problem for taxpayers adopting a cost-sharing approach with respect to intangibles. For companies having extensive research and development activities, it will be extremely difficult to determine the value of previously developed intangibles, and to the extent that this cannot be done presumably the regulations preclude the use of the cost-sharing arrangement procedures.

Sale of tangible property

Now we come to the portion of the regulations that has received the most attention from the business community—inter-company pricing. Under the proposed regulations, the District Director is authorized to make allocations in cases in which an arm's-length price is not charged on sales of tangible property by the members of a controlled group of entities ("controlled sales"). The regulations give three methods of determining an arm's-length price and the standards for applying each method. The methods are listed in accordance with the Internal Revenue Service's preference of use, and to the extent the information is available to determine a price under more than one method, the method which the Revenue Service considers to be most accurate is to be used.

The prescribed methods for determining an arm's-length price, listed in order of preference, are as follows:

- (1) **Comparable uncontrolled price method**—The price that is charged on similar sales involving unrelated parties.
- (2) **Resale price method**—The price equal to the resale price of the item to an uncontrolled buyer less the markup appropriate to such resale. This method must be used if all the following circumstances exist:
 - (a) There are no comparable uncontrolled sales.
 - (b) A resale price is available with respect to sales made within a reasonable time of the original sale.
 - (c) The buyer has not added substantially to the value of the product by alterations made prior to resale.
 - (d) The buyer has not added substantially to the value of the product by use of its own intangible property prior to resale.
- (3) **Cost-plus method**—The price derived by adding to the cost of producing the property an amount equal to the cost multiplied by the appropriate gross profit percentage earned by the seller, or another party, on uncontrolled sales of similar property. The following characteristics should be considered in determining whether an uncontrolled sale is "similar":
 - (a) The type of property involved in the sale.
 - (b) The functions performed by the seller with respect to the property sold.
 - (c) The effect of any intangible property of the seller associated with the property sold.
 - (d) The geographical market in which the functions are performed by the seller.

It should be noted that there is a relief provision in the regulations with respect to the above described methods. The regulations state that if the taxpayer can demonstrate to the satisfaction of the District Director that, considering all the facts and circumstances, some other method of pricing was actually used on a consistent basis and such method is clearly more appropriate than the three methods specified in the regulations, then the method used by the taxpayer will be acceptable. It may, however, be difficult to convince the Internal Revenue Service that another method is more appropriate than those specified in the proposed regulations.

Observations on the proposed Section 482 Regulations

In connection with these proposed regulations, many companies and numerous professional groups and trade organizations have submitted comments to the Treasury. In Secretary Surrey's recent speech to the National Foreign Trade Council, he stated that these comments took about 200 pages to summarize, thus giving a clear indication of the interest and magnitude of concern that these regulations have generated. Hopefully, the proposed regulations will be revised and in their final form will provide a more practical business approach to transactions between related parties.

I will make a few general remarks on the pricing portion of the regulations, since this seems to be the area of widest interest. Also, I will comment briefly on certain concepts that I feel should be given consideration by the Internal Revenue Service in its over-all approach to Section 482 allocations.

Inter-Company Pricing

Businessmen are concerned, it seems to me, about the basic underlying principle of this portion of the regulations, namely, the requirement for related parties to deal with each other on an arm's-length basis. While this approach by the Treasury is understandable, it seems to ignore the fact that such sales are not in fact being made at arm's-length. There are, indeed, many factors that enter into arm's-length negotiations and it is impossible in most instances of inter-company sales to determine what an unrelated party "would have been paid for the property under the same circumstances." This is certainly true in the United States, and there are generally additional factors when a foreign sales transaction is involved. For example, high customs duties of a foreign country could certainly affect the price to be charged to anyone—related or unrelated.

I had hoped that the final regulations would only establish guidelines for determining appropriate prices, but on the basis of recent statements by Treasury personnel, this would not appear to be the case. As I

mentioned before, the proposed regulations provide a rigid order of use of various methods of determining the "proper" inter-company price. I really see no reason why a taxpayer should not be able to use any of the methods set forth in the proposed regulations in actually establishing its prices and feel confident that if such methods are used consistently, they will not be challenged, in principle, by the Internal Revenue Service.

In addition, it seems in order for the regulations to specifically authorize the granting of discounts to related parties that are not necessarily given to unrelated parties. When large quantities are involved in sales to related parties, the granting of reasonable quantity discounts should be considered as something that generally would be done in an arm's-length transaction. Going even further, the related purchaser is usually required to use the related source of supply, and sales effort to retain the related purchaser as a customer is not required. This fact alone could be adequate reason for discounts on prices that are charged to the related party.

Also, in announcing the release of the proposed regulations on August 2, 1966, the Treasury stated that the Internal Revenue Service is following a policy of making Section 482 allocations only in "significant" cases and not in cases where "minimal" amounts are involved. In the case of inter-company pricing, it would certainly seem appropriate if as many controversies as possible between the Internal Revenue Service and the taxpayers are avoided by establishing a "floor" below which allocations will not be made.

Over-all approach to Section 482

I think we all recognize that the greatest benefit will be obtained for all concerned if taxpayers make a sincere effort to clearly reflect income. It appears to me that the greatest concern of U. S. executives responsible for the international financial affairs of U. S. business is that, in administering the regulations as proposed, the Internal Revenue Service may indiscriminately challenge international transactions with related corporations. I do not believe that this is the intention of the regulations, but I do fear that this may be a fair prediction of the results in some cases. I would hope that the final regulations would provide some relief in this area by stating that allocations would not be made unless material in amount and clearly required to prevent avoidance of U. S. Income Tax.

As to the effective date of these regulations, many U. S. businessmen involved in foreign operations feel that the recent emphasis on the application of Section 482 is tantamount to a retroactive change in the law. Admittedly, Revenue Procedures 64-54 and 65-17, which I mentioned at the beginning of my talk, recognize that harsh results could occur from

retroactive application of Section 482 in certain cases. The current proposed regulations were, in large part, not made public until the summer of 1966, and the final regulations, as I said, are not yet issued. Due to the intricate proposed rules and the complex nature of the subject, it is highly unlikely that most taxpayers have fully complied with the principles contained in these regulations. In view of this fact, it seems to me that, from an administrative standpoint, the Internal Revenue Service should deal leniently with Section 482 cases involving transactions entered into prior to the issuance of final regulations. This would certainly be a reasonable approach in situations where sound business reasoning was utilized in the costing of inter-company transactions and U. S. tax avoidance was not a major factor.

Lastly, it would seem appropriate to extend the offset principle of Revenue Procedure 64-54, which is now applicable only through years beginning prior to 1965. I feel strongly that this offset principle should be applied for years beginning after December 31, 1964 and that it should be continued indefinitely. It would certainly seem appropriate for the Internal Revenue Service to permit taxpayers to receive relief under this approach in cases where a taxpayer has attempted to comply with the principles contained in the Section 482 regulations but where the Internal Revenue Service has, nevertheless, made Section 482 allocations upon examination. Unless the offset principle of Revenue Procedure 64-54 is extended, it is quite likely that taxpayers subjected to allocations under Section 482 will suffer economic double taxation in many cases even though they have made a sincere good-faith effort to clearly reflect income. It does not seem appropriate to permit this economic double taxation of such taxpayers to occur, yet it might seem inappropriate for the U. S. Treasury to suffer a revenue loss equal to the amount of the offset. In this connection, a procedure might be established requiring that a taxpayer first make a reasonable effort to obtain a refund of the applicable foreign income tax before the relief will be granted. Where appropriate, it would certainly seem in order for the Internal Revenue Service to assist the taxpayer in negotiating directly with the foreign government involved, when income tax treaties with the U. S. exist. Unless the offset principle is allowed or unless the foreign tax refunds are received, the U. S. taxpayer subject to a Section 482 allocation may find himself caught between the two governments with little or no chance of avoiding double taxation.

