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Canada-United States Tax Accounting—Competent Authority, Section 482 Transfers and Joint Audits

*by George G. Goodrich**

I. INTRODUCTION

The overriding theme of the afternoon session, Recent Tax Developments and Issues Affecting Canada-United States Transnational Business Activities, has provided a forum for reviewing the major areas of contact between nationals of the respective countries.

In this session, the focus will be on specific areas of the tax laws of the respective countries which are being used by the governments of the respective countries to ensure that multinationals deal with each other on an arms-length basis.

The topics preceding this discussion have noted the attitude of Canadian taxpayers looking toward the U.S., or vice versa, and have focused on the political environment in the respective countries and, therefore, the intangible factors which must be taken into account when making various business and investment decisions. Several have focused on the cross-border contact, not necessarily dwelling on the conflict, but rather on the motivations for the contact, particularly cross-border investment and, more commonly, cross-border trade.

Despite the many common attributes, one cannot lose sight of the fact that the countries do have separate legal and taxing systems. Therefore, common practices which may make sense may be in conflict. With the ever-increasing activity across the border by nationals of both countries, the opportunity for the tax laws of the respective countries being in conflict increases. Therefore, formal programs have been adopted by the respective countries to specifically focus on taxpayers engaged in cross-border transactions, and then relief measures have been put into effect by the respective countries in an attempt to avoid double taxing the nationals of these respective countries.

This review will focus on recent developments in proposed adjustments pursuant to section 482 of the Internal Revenue Code (I.R.C.), the formal joint audit or simultaneous audit program announced by both the United States and Canada, and the competent authority relief provisions available by reason of the Canada-United States Income Tax Treaty.

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II. INTERCOMPANY TRANSACTIONS (INTERNAL REVENUE CODE § 482)

The traditional approach to discussions of this subject is to focus the attention on the competent authority mechanism of the Canada-United States Income Tax Treaty. Certainly such an approach is popular since one can review the legal principles of international law, the intent of the treaty articles and matters of jurisdiction. However, from a procedural standpoint and certainly from a tax accounting standpoint, a discussion of the competent authority procedures tends to put the emphasis in the wrong place. Proper focus should first be given to the planning opportunities in the areas of intercompany transactions, then the methods of coping with proposed adjustments at the examining agent level, and finally the implementation of the competent authority relief measures.

A. *In General*

Internal Revenue Code section 482 provides that the Secretary may allocate gross income, deductions, credits, or allowances among related taxpayers to prevent the evasion of taxes or to clearly reflect the income of the related parties. Related parties under I.R.C. § 482 are defined as two or more organizations, trades, or businesses owned or controlled either directly or indirectly by the same interests. This section delegates vague and unusually broad powers to the Commissioner. Developments of the law under I.R.C. § 482 are accordingly few and far between.

The purpose of I.R.C. § 482 is to prevent shifting of income from one commonly controlled entity to another. Common control means effective control. The regulations refer to "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised." The mere existence of commonly controlled entities and the unexercised power to shift income among them is not the focus of I.R.C. § 482, however. The focus is on shifting income between the entities.

Motivation is also irrelevant. The question is whether taxpayers have dealt with controlled entities in the same manner as uncontrolled entities. The regulations provide that the true taxable income of a controlled taxpayer is to be determined according to the standard of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. There is little agreement among the courts concerning what dealing at arm's length means in any particular case.

I.R.C. § 482 refers to organizations, trades, or businesses. The regulations interpret these terms as including any sole proprietorship, partnership, trust, estate, association, or corporation "irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return."

B. Common Issues Under I.R.C. § 482

1. Imputed Interest

Imputed interest had been a common issue for a number of years until Revenue Canada announced, in late 1977, that if interest was not stated pursuant to the contract, it would no longer grant deductions in Canada under any imputed interest concept. Experience to date has been that this is no longer an issue.

2. Royalty Arrangements

During the 1970's, both the Internal Revenue Service and Revenue Canada actively proposed adjustments to properly reflect arm's length royalty rates. In recent years, this has also been less of an area of controversy.

3. Intercompany Pricing

The most prominent I.R.C. § 482 issue tends to be intercompany pricing on sales of tangible property. The regulations prescribe three specific mechanisms for pricing on an uncontrolled third party basis, and a fourth method for all other situations in which an uncontrolled third party price cannot be determined. Most I.R.C. § 482 disputes arise because arriving at an uncontrolled third party price is not practical, and the regulations provide no formulaic substitute.

The three methods set forth in the regulations are: (a) comparable uncontrolled price method; (b) resale price method; and (c) cost plus method. The methods are to be used in this order. In other words, in an allocation case, the Commissioner should look first for an uncontrolled transaction, secondly for a resale yardstick, and finally at cost of the goods plus an arm's length profit. If none of these apply, a fourth or "other" method is used. There is no requirement that only one pricing method be used for a particular taxpayer. A taxpayer may sell many products in different states of completion at several different levels of distribution in different geographic markets. A pricing method for one situation may not be appropriate for another.

The pricing methods of the regulations apply to all transfers of property between related entities other than transfers of intangible property and use of tangible property. Thus, the regulations apply to transfers of capital assets and sales of I.R.C. § 1231 property in addition to intercompany sales of inventory items.

a. Comparable Uncontrolled Price

The first and thus preferred pricing method specified in the Regulations is the comparable uncontrolled price method. The arm's length price of controlled sales is deemed to be equal to the price paid in compa-

able uncontrolled sales. An uncontrolled sale is defined in the regulations as a sale in which the seller and buyer are not members of the same controlled group as, for example, sales made to a member of the controlled group by an unrelated party, and sales in which the parties are not members of the same controlled group and are not related to each other. Sales made at unrealistic prices in small quantities cannot be used as comparable uncontrolled sales. Uncontrolled sales are comparable if the circumstances surrounding the sale are either identical to the controlled sales or so nearly identical that differences can be reflected by adjustments to the price. Adjustments are to be made when they reflect differences that have a definite and reasonably ascertainable effect on price. The uncontrolled sale as adjusted then constitutes the comparable uncontrolled sale price. If an unreasonable number of adjustments are necessary, then the uncontrolled sale is probably not a comparable sale.

b. Resale Price

If an arm's length price cannot be established through use of a comparable uncontrolled price, the regulations specify that the resale price method must be used. An arm's length price is determined under the resale price method by reducing the resale price by a markup percentage. The appropriate markup percentage is determined from uncontrolled sales of the related buyer-reseller or, if none are available, from uncontrolled sales made by other resellers under similar circumstances.

The resale price method is appropriate in situations where a sale is made to a controlled entity that then resells to an unrelated third party, and there are no comparable uncontrolled prices. A portion of the resale price may be attributable to value added by the related party. In that case, adjustments are to be made to the resale price.

c. Cost-Plus Method

This method is primarily used by exporters of components or unfinished goods that have substantial value added to them by the purchasing subsidiaries. The appropriate profit percentage is determined from comparable uncontrolled sales of the seller or unrelated parties.

d. Fourth Method

The regulations provide that if none of the above three methods can be reasonably applied under the circumstances of a particular case, an alternative method can be used. The fourth method can be a variation of the other three or an entirely different approach.

e. OECD and Canadian Developments

The Organization for Economic Cooperation and Development (OECD), Germany and Canada have developed intercompany pricing

guidelines which tend to mirror the I.R.C. § 482 regulations. Certain foreign governments have established task forces to review intercompany pricing as well. I.R.C. § 482 and its equivalent, on a worldwide basis, appears to be a continuously increasing factor in international taxes as the U.S. and major commercial countries battle for even bigger slices of the earnings of multinational corporations.

It is important to note that the OECD and Canadian pricing guidelines espouse arm's length pricing as a key concept. Resale and cost-plus pricing are also considered. The fourth method—any other reasonable method—is provided primarily as a functional analysis or profit split approach. Informed commentators are more and more espousing a profit split approach based on a functional analysis since at least half of all pricing cases do not fit into the three classical methods. The functional analysis, however, is incorporated in the IRS agent's manual and is not a method espoused in the I.R.C. § 482 regulations themselves.

f. Use of Tangible Property

If a member of a controlled group transfers possession, use or occupancy of tangible property by lease or other arrangement to another member at a charge other than an arm's length rental, the IRS can make an allocation to reflect an arm's length charge based on transactions between unrelated parties, and a safe haven charge.

The true arm's length charge applies if the owner or user of the property is engaged in the trade or business of renting similar property. It is equal to the amount charged in transactions between unrelated parties. The safe haven charge applies when neither party is engaged in the trade or business of renting similar property. It is equal to the sum of various expenses connected with the property unless a more appropriate charge can be established by reference to third party transactions.

g. Transfer of Intangibles

I.R.C. § 482 applies as well to the transfer and use of intangible property between related entities. Treasury Regulation § 1.482-2(d)(1) provides as follows:

[W]here intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities . . . to another member of the group . . . for other than an arm's length consideration, the district director may make appropriate allocations to reflect an arm's length consideration for such property or its use.

The definition of arm's length consideration is that which would be adopted in transactions between unrelated parties. It may take several different forms. The regulations mention royalties, lump sum payments, and other forms that might have been adopted by unrelated parties under

the circumstances.

Intangible assets are defined in a very broad manner. Per Treasury Regulation § 1.482-2(d)(3) they include the following:

(1) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(2) Copyrights, literary, musical, or artistic compositions, and other similar items;

(3) Trademarks, trade names, brand names, and other similar items;

(4) Franchises, licenses, contracts, and other similar items;

(5) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

The application of I.R.C. § 482 to a transfer or use of intangibles usually arises in the context of licensing agreements or other arrangements for the use of the intangible assets of a domestic parent by a foreign subsidiary. The question raised is whether a portion of the gross income of the subsidiary should be allocated to the parent to reflect an arm's length charge for use of the intangibles by the subsidiary. In the absence of comparable third party transactions, the regulations specify factors that may be considered in determining the proper amount of consideration.

C. I.R.C. § 482 and the Nonrecognition Provisions

Recent IRS rulings, audit activity, and litigating posture document that the Internal Revenue Service (IRS) is attempting to apply I.R.C. § 482 to transactions otherwise qualifying for nonrecognition treatment. This is another facet of the IRS attempt to create income. The key areas of controversy involve I.R.C. § 351.

Treasury Regulation § 1.482-1(d)(5) provides that I.R.C. § 482 may be applied to prevent the avoidance of taxes or clearly to reflect income where the transaction otherwise would come under a nonrecognition provision of the Internal Revenue Code such as I.R.C. § 351. I.R.C. § 367 has subsumed most of the international tax aspects of Treasury Regulation § 1.482-1(d)(5).

D. Summary

In the past few years, we have seen considerable audit activity by Revenue Canada in proposing adjustment to intercompany pricing strategies. The Canadian Government is focusing on specific industries, for instance, in the pharmaceutical, steel, textile and chemical industries. They appear to have at times attempted to restrict pricing to the charge for standard products. This would appear to be a case where the taxing authorities may not permit a Canadian subsidiary to be charged for technological advances, product improvement or other intangibles associated

with a private brand. Extreme concern has been expressed regarding the potential expansion of such concepts to other industries.

In 1980, the IRS announced that a study under I.R.C. § 482 was to be conducted. The purpose of the new study was to review the International Administration of I.R.C. § 482 and particularly to:

1. Identify the frequency and trend of Section 482 adjustments and the most prominent type of adjustments between U.S. companies and foreign entities.

2. Identify the geographic location of the foreign entities involved in such adjustments.

3. Determine the geographic area of noncompliance with the principles of I.R.C. § 482.

4. Develop "profiles" of the United States and foreign entities most likely to be engaged in commercial activities susceptible to the application of I.R.C. § 482.

5. Determine whether proposed legislation and/or regulations should be developed for Department of Treasury consideration.

This study was completed in 1983 and released to the public in March 1984. Based on a total of 823 international cases the study determined:

- (1) 3,080 possible I.R.C. § 482 adjustments were considered, with income adjustments of approximately \$4.4 billion having been recommended in 75% of the issues. The average dollar adjustment proposed was approximately \$1.9 million.

- (2) Almost 18% or \$772 million of the total recommended adjustments involved transactions with foreign entities located in tax havens.

In general, it is clear from this study report that the Internal Revenue Service has increased its efforts in examining intercompany transactions with a view toward making adjustments under I.R.C. § 482.

III. SIMULTANEOUS EXAMINATION/JOINT AUDIT PROGRAMS

A. *Background*

With the growth of multinational companies and the relative ease with which international activities are conducted throughout the world, tax agencies have found it difficult to monitor compliance with their country's tax laws strictly from information available within their country's boundaries. For this reason, the provisions of tax treaties aimed at enhancing tax administration have become extremely important. Since 1970, there has been a continuing growth in intergovernmental cooperative activities in the international tax area. Exchange of information provisions of tax treaties are the cornerstone of these activities.

The scope of exchange of information under tax treaties, in general, is reflected in Article 26 of the OECD, United Nations and U.S. Treasury models, which provides that: The competent authorities of the Con-

tracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (Personal Scope). Of the 34 income tax treaties the United States currently has in force, only its treaty with the Soviet Union does not provide for the exchange of tax information. In addition, while to date the principal cooperative activities in exchange of information have come from the income tax treaties, each of the 14 estate and gift tax treaties the United States currently has in force also provides for exchange of information.

In 1977, the United States and Canadian governments approved a program to commence simultaneous examinations of multinational companies operating within both countries. The purpose of the program was to ensure compliance with the taxing statutes of the respective countries.

The U.S. approach initially appeared to focus on transactions between nationals of the respective countries. The Canadian intent appeared to be on tax abuse through tax haven operations. Several cases have been completed to date and, in general, the program has been judged a success and will continue.

Income tax treaties generally provide for the exchange of the following tax information:

1. Information concerning double taxation cases considered under the mutual agreement procedure of the tax treaty;
2. Information, generally dealing with investment income paid to a resident of the treaty partner, which is sent to the treaty partner on a routine or automatic basis;
3. Information provided upon request dealing with a specific taxpayer;
4. Information provided in accordance with a simultaneous examination or criminal investigation of the same multinational taxpayer;
5. Spontaneous exchanges of information uncovered during an audit or other investigation of a specific taxpayer;
6. Industry-wide exchanges of information and exchanges of "Know-How."

In connection with efforts to resolve double taxation cases, tax information is exchanged to the extent necessary to resolve the tax dispute under consideration. The taxpayer requesting the assistance of the U.S. Competent Authority is apprised of the information provided to, and positions taken with, the treaty partner.

The largest program for the exchange of information involves the "automatic" or "routine" exchanges of information. In 1982, the IRS sent treaty partners about 500,000 documents and received about 800,000 documents. (Canada supplied over 90% of those foreign information documents). The routine exchanges generally identify taxpayer recipients of investment income (dividends, interest, royalties) as follows:

1. Information dealing with U.S. source income (reported on Form 1042S) is sent to the treaty partner (except Soviet Union) where the alien claims residence. No information is sent dealing with U.S. citizens, residents or corporations.

2. Basic U.S. data is extracted annually from information returns (1042S) filed by U.S. withholding agents (brokerage houses, etc.) and run through a computer.

3. Each treaty partner is furnished with a copy of the computer printouts summarizing information relative to that country.

4. Germany and Canada are furnished magnetic tapes in lieu of printouts. Only Germany sends magnetic tapes to the United States.

Currently, each treaty country uses one or more types of documents in their native language for purposes of exchange, which makes processing difficult. However, the OECD has developed a standard multilingual document that appears likely to be adopted by most countries. Foreign information documents received from treaty partners which deal with U.S. citizens, residents and U.S. corporations are perfected in the IRS' Foreign Information Document Program (IRS—Form 1099 matching program). Lack of taxpayer identification numbers on foreign information documents makes matching difficult and requires additional time perfecting the information document. However, the next step may be a standard international tax number.

An area of concern to many taxpayers is that of the specific requests for information. Such requests for information are considered on a case by case basis. It is clear that "fishing expeditions" by treaty partners are not permitted; the treaty partner must: 1) specifically identify the taxpayer and the information requested; 2) show that the taxpayer is subject to the treaty partner's tax laws; and 3) show that the requested information is required in good faith with respect to transactions or facts material for determining a tax liability covered by the tax treaty. To date, there have been only a small number of specific requests each year—perhaps a couple of hundred requests (United States versus all treaty partners) going each way annually.

Typical specific requests are for records on: 1) ownership of property and control of corporations; 2) financial transactions; 3) citizenship and residency; 4) verification of filing and reporting income and expenses (such as commissions, fees, payment of reported expenses). It should be noted that, to the extent the requested information is contained in IRS files, a taxpayer will not be advised that tax information was provided to a treaty partner. However, if the U.S. taxpayer is not under current examination by the IRS and the information is not in the IRS files, the taxpayer will be advised of the request. Also, the taxpayer will be advised of the request for information from a tax treaty partner if the Service believes that the information may constitute a trade, business, industrial, commercial or professional secret or trade process. This has been an area of concern for many taxpayers particularly when dealing with intercom-

pany pricing issues.

The United States does not require a U.S. tax interest to supply information on behalf of a tax treaty partner. Furthermore, it has been held that the limitation on the authority of the IRS to examine records and to compel testimony in a domestic tax investigation also applies to a summons issued by the IRS in compliance with a request by a tax partner. On the other hand, the courts have upheld the IRS authority to use its administrative procedures, including administrative summons authority, where the purpose is solely to assist the investigation of a foreign (e.g. Canadian) potential tax liability. In addition, it should be noted that Treasury's Proposed Model Income Tax Treaty expands the standard exchange of information to provide that, if requested:

[T]he competent authority of the other Contracting State shall provide information . . . in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

Obviously, the Service is very enthusiastic about this program as it provides accessibility to information not previously available. In general, the following procedural guidelines have been established:

1. Each country separately and simultaneously examines the related taxpayer or taxpayers under its jurisdiction.
2. The tax administrators from both countries sit down to plan audit strategy. Such examinations could involve a number of countries all focusing on the same activity of the multinational.
3. Examinations are coordinated as to tax year, issue, audit approach and direction each country will take and information to be exchanged.
4. Cases agreed to be considered under the simultaneous examination procedure will be initiated by a formal exchange of letters between the competent authorities.
5. The competent authorities will appoint a "Designated Representative," usually a case of group manager, to actually coordinate the examinations with the designated representative of the treaty partner.
6. Information obtained during the examination is forwarded through the Assistant Commissioner (Examination) to the treaty partner competent authority.
7. A company is notified when it is being subjected to a simultaneous examination, at least under the U.S.-Canadian program. Certain U.S. treaty partners will not notify the taxpayer.

B. Multilateral Audit Programs

An outgrowth of the simultaneous examinations is the multilateral

simultaneous examinations—several countries examining the same taxpayer at the same time. The requirements of multilateral exchange agreements are:

1. Each country participating in the program must have a tax treaty authorizing exchange of information with the other countries participating.
2. Specific exchanges of information between the United States and a treaty partner are done in accordance with the respective tax treaties. The United States will not provide information received from one treaty partner to another since this would generally be in violation of the secrecy provisions of the tax treaties.

C. Spontaneous Exchanges

The U.S. has also entered into programs for the spontaneous exchange of information. Generally, such programs authorize treaty partners to provide gratuitously, without request, information discovered during a tax examination or investigation "which suggests or establishes noncompliance with the tax laws of a treaty partner." Such information can involve U.S. citizens, residents and domestic corporations, as well as nonresident aliens and foreign corporations.

Currently, Spontaneous Exchange Programs of the United States are limited to the United Kingdom, France and Germany. The current income tax treaties with Canada and the Soviet Union do not provide for spontaneous exchanges of information. All information is forwarded through the Assistant Commissioner (Examination).

The IRS realizes the sensitivity of this program and has indicated it will "monitor" reciprocity with each country with which the United States engages in spontaneous exchanges of information to ensure that mutual cooperation is maintained. A taxpayer, however, is not specifically notified when information is spontaneously provided to a treaty partner.

IV. EXCHANGES OF INDUSTRY INFORMATION

In connection with the expanded programs of many countries, particularly the United States and Canada, in auditing intercompany pricing strategies, an industry-wide exchange of information program has also been instituted. The objective of the program is to secure comprehensive data on worldwide industry and operating patterns through an exchange of experiences in examining multinational enterprises in specific industries. The program is intended to complement the IRS Industry Specialization Program.

The scope of the industry-wide exchange of information is established by an exchange of letters between the competent authorities. Generally, the Assistant Commissioner (Examination) will designate an Assistant Regional Commissioner (Examination), whose region has the necessary expertise to coordinate the industry-wide exchange, to act for

the IRS.

Industries such as electronics, heavy construction, aluminum, banking, insurance, grain, oil and shipping have been selected. General information about the industry is shared between the countries. Specific taxpayer information is not supposed to be exchanged; however, it can be if a specific request is made. Audit techniques and approaches are discussed, comparative methodology in establishing arm's length standards are exchanged, and current industry events of mutual interest are considered. The program is extremely important in that it can develop the various tax authorities' tax views toward specific industry activity. It may also lead to establishing safe haven guidelines for industry-wide transactions, accepted by a number of foreign tax authorities. However, at the same time, prejudices of one tax authority toward an accepted industry-wide transaction may be unjustly conveyed to other tax authorities.

Despite the ability of the various governments to exchange significant amounts of information concerning multinational taxpayers operating within their boundaries, tax treaties generally limit the disclosure of the information obtained. Article 26 of Treasury's Proposed Model Income Tax Treaty provides that:

Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

Older U.S. tax treaties do not include persons involved in the "administration of taxes" as persons entitled to information obtained from a tax treaty partner. As stated in the Treasury Department's Technical Explanation to Article 25 of the New United States-Australia Income Tax Treaty: "[P]ersons involved in the administration of taxes covered by the Convention include legislative bodies involved in the administration of taxes and their agents such as, for example, the United States General Accounting Office, . . ." All new tax treaties routinely provide for General Accounting Office (GAO) access to information obtained under a tax treaty and resolve (with regard to the new treaties) the controversy over the IRS position that the GAO was not entitled to review such information in its oversight capacity.

Tax treaties also generally limit the type of information that can be provided to a treaty partner, so that there is no obligation:

1. To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
2. To supply information which is not obtainable under the laws or

in the normal course of the administration of that or of the other Contracting States;

3. To supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (order public).

(See Article 26, Paragraph 2 of the Treasury's Proposed Model Income Tax Treaty). The disclosure of tax return information is generally governed under I.R.C. § 6103. I.R.C. § 6103(k)(4) provides that returns or return information may be disclosed in accordance with a tax treaty or other convention relating to the exchange of tax information.

Use of information obtained under a tax treaty will be governed by the treaty, as well as the limitations provided under the Internal Revenue Code. A taxpayer, generally, may have access to his or her tax return and return information. However, information obtained under a tax treaty will not be disclosed to a taxpayer if, after consulting with the tax treaty partner who provided such information, the Service determines that federal tax administration would be seriously impaired by disclosing such information to the taxpayer.

In a further effort to improve the audit techniques and procedures of the treaty partners, groups of tax administrators have formed to enhance tax administration. In 1980, the Pacific Association of Tax Administrators (PATA) was formed with high level tax officials of Japan, Australia, Canada and the U.S. In 1970, a similar group had been established in Europe, known as the "Group of Four," and included tax officials from Germany, France, the United Kingdom and the United States. Under these programs, high level tax officials meet at least once a year to: 1) discuss and formulate cooperative projects to be handled at lower levels during the year; 2) engage in multilateral exchanges of information on taxpayers and on more general tax administration matters; and 3) seek solutions to recurring international tax administration problems, such as abuse of tax laws through the use of tax havens.

Exchanges of information are done in accordance with the tax treaties between the respective countries in each group. The last meeting of PATA was held in Tokyo, Japan in September 1983 and the last meeting of the Group of Four was held in Charleston, South Carolina in November 1983.

Such groups have also enacted informal programs for the exchanges of "Know-How." The programs are aimed at initiating and expanding international cooperation with nontreaty countries and treaty countries with which there is little activity. The following general information is exchanged: 1) patterns and operations of selected multinational industries; 2) examination techniques and expertise; 3) training; and 4) views on the roles of various specialists in tax examinations.

V. COMPETENT AUTHORITY (MUTUAL AGREEMENT PROCEDURES)

The existing treaty between the United States and Canada basically provides for relief from double taxation where nationals of the respective countries are faced with conflicting taxing statutes. The treaty is over 30 years old and, up until 1970, while it was generally agreed that there would be no double taxation of nationals of the United States and Canada, little was known on how to mechanically achieve such results. Most taxpayers attempted to compromise at the agent level. Many of these attempts were unsatisfactory and did result in double taxation. An appeal of an agent's findings often achieved the same result. Appellate conferees were generally unwilling to follow court cases since, at the time, most cases had been favorable to the taxpayer.

In 1970, the formalization of the competent authority procedures in the United States was achieved through the issuance of Revenue Procedure 70-18, which provided that the competent authorities of the respective countries shall endeavor to reach a satisfactory settlement to avoid double taxation. If the taxpayer did not agree with the proposal, he could pursue his other procedural and administrative remedies through the appellate system or the courts. In 1971, Revenue Canada's information circular 71-17 basically provided similar terms.

Since 1971, the statistics on competent authority relief indicate that there have been 808 cases received by the U.S. competent authority. Of this total, 396 allocation cases have been resolved. Of those cases that were negotiated, 236 cases were closed with full relief. There have been 33 cases closed with partial relief, and 22 cases closed without any relief at all. Most of those cases settled have involved United States-Canadian issues, and most of the 236 cases closed with full relief involved United States-Canadian issues. (See Tables A through C, appendix, for further statistics). With respect to the 22 cases closed without any relief, double taxation was not alleviated. Apparently, every one of these cases involved procedural difficulties in approaching the other country.

The current inventory in the United States is about 170 cases. The timetable for the completion of cases, based on the average processing time from 1970 to 1973, is about 16 months for processing the competent authority cases. Many taxpayers have experienced timetables in excess of five years. Recent experience has been that such cases take about two years, despite an objective of 12 to 15 months. A point that is bothersome to Treasury is that reports from the field indicate that there are approximately 1,100 I.R.C. § 482 cases in process (which has been confirmed by the recently completed Treasury study); however, these cases apparently are not being appealed to competent authority.

One of the concepts that has emerged is a preference that cases proceed through the appellate level before competent authority relief is sought. The rationale is that competent authority would not have to develop the cases; however, it was felt that they needed to have a very good

technical background in the case before they appeared before the Canadian competent authority.

In prior years, a *de minimis* standard had been established for allocation cases. Any amount under \$25,000 apparently was always considered *de minimis*; whereas, an amount over \$100,000 could never be considered *de minimis*. In recent months, such guidelines have been abandoned and should be regarded as an administrative convenience to expedite older or nuisance cases.

In an effort to minimize the chances of procedural matters becoming a barrier to competent authority negotiations, one of the features being used by the IRS is the "early warning system." The IRS, soon after entering into a case, will send a letter to the taxpayer indicating to the taxpayer that it is investigating an I.R.C. § 482-type issue, and that the taxpayer should protect the statute of limitations in the foreign jurisdiction. If the taxpayer does not protect the statute in the foreign jurisdiction after having received such a letter, and if the IRS does propose an I.R.C. § 482 issue and the competent authority is unable to intervene because the statute is closed in the foreign jurisdiction, the taxpayer will not get relief on that issue.

Notwithstanding the movement to protect U.S. taxpayers, the IRS has issued several rulings which are restrictive in this area. Revenue Ruling 76-508 indicates that a taxpayer must pursue all procedural remedies available to it if it intends to use a foreign tax credit with respect to distributions from a foreign entity. For instance, if an I.R.C. § 482 issue is initiated by the IRS, involving an intercompany pricing issue with a Canadian subsidiary, and if the taxpayer would normally alleviate the burden by repatriating high taxed earnings from Canada, the taxpayer will not be entitled to the full foreign tax credit because a portion of that tax paid in Canada is considered "voluntary" since the taxpayer did not pursue the deduction in Canada with respect to the I.R.C. § 482 issue.

While Revenue Procedure 70-18 provided guidance in the area of allocation cases, considerable uncertainty existed with respect to nonallocation cases. Revenue Ruling 77-16, 1977-1 C.B. 573 prescribes the procedures of the Internal Revenue Service with regard to requests by taxpayers for the assistance of the U.S. competent authority in order to resolve nonallocation cases.

Such issues involve the availability to a United States taxpayer of foreign tax credits, exemptions from foreign tax, reduced rates of foreign tax, and other benefits and safeguards provided under income tax treaties. Access to the United States competent authority pursuant to Revenue Ruling 77-16 is generally limited to a United States taxpayer, which is defined to include only a citizen or resident of the United States, a domestic partnership, a domestic corporation, or an estate or trust (other than a foreign estate or foreign trust). Specifically, section 5 of Revenue Ruling 77-16 states in part:

The United States competent authority will not act for foreign individuals, partnerships, estates, trusts, corporations, associations, or other entities of a treaty country, who claim that they are being taxed by the United States in contravention of a tax treaty, except in the one instance where the foreign government denies a foreign tax credit in respect of income taxed by the United States and only after such taxpayer has exhausted all legal remedies within the taxpayer's own country. Requests addressed to the United States competent authority in cases described in this section in which the United States competent authority will not act will be referred to the competent authority of the treaty country.

Article 25 of both the 1977 and proposed 1981 Treasury Department Model Income Tax Treaty provides that a person must present his case to the competent authority of the contracting state of which he is a resident. The fact that access to the United States competent authority is limited to United States taxpayers may work undue hardships, particularly when the United States is the only taxing jurisdiction with a real economic interest in the taxpayer's obtaining the benefit of the tax treaty to which he is entitled.

A problem might also arise under the September 26, 1980 income tax treaty between Canada and the United States (not yet in effect). Paragraph 8 of Article XXV of that treaty provides that the general nondiscrimination provisions of Paragraph 7 shall not preclude the operation of any provisions of the taxation laws of a contracting state relating to the deductibility of interest paid to nonresidents. The technical explanation accompanying Article XXV of the treaty states as follows:

Paragraph 7 concerns the right of a resident of a Contracting State to claim deductions for purposes of computing taxable profits in the case of disbursements made to a resident of the other Contracting State. Such disbursements shall be deductible under the same conditions as if they had been made to a resident of the first-mentioned State. These provisions do not apply to amounts to which Paragraph 1 of Article IX (Related Persons), Paragraph 7 of Article XI (Interest), or Paragraph 7 of Article XII (Royalties) apply. Paragraph 7 of Article XXV also provides that, for purposes of determining the taxable capital of a resident of a Contracting State, any debts of such persons to a resident of the other Contracting State shall be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State. This portion of Paragraph 7 relates to Article XXIII (Capital). Paragraph 8 provides that, notwithstanding the provisions of Paragraph 7, a Contracting State may enforce the provisions of its taxation laws relating to the deductibility of interest, in force on September 26, 1980, or as modified subsequent to that date in a manner that does not change the general nature of the provisions in force on September 26, 1980; or which are adopted after September 26, 1980, and are designed to ensure that nonresidents do not enjoy a more favorable tax treatment under the taxation laws of that State than that enjoyed by residents. Thus Canada may continue to limit the deductions for interest paid to certain nonresidents as

provided in Section 18(4) of Part I of the Income Tax Act.

Section 18(4) of Part I of the Income Tax Act (Canada) provides essentially that in computing the income of a corporation resident in Canada, no deduction shall be allowed with respect to interest paid to non-resident shareholders to the extent of the interest attributable to that portion of the debts to nonresident shareholders which exceed three times the equity of the corporation. For example, assume a United States corporation has a Canadian subsidiary which pays interest to the United States parent. For United States tax purposes, the payments are characterized as interest, but under this special provision the payments are characterized as nondeductible dividends, rather than deductible interest, for Canadian income tax purposes. Thus, the Canadian subsidiary is not entitled to a deduction in computing its Canadian income tax liability, but the payments of interest do not entitle the United States parent to any deemed paid foreign tax credit with respect to the Canadian income taxes paid thereon by the Canadian subsidiary.

Where the United States-Canada treaty currently in force is virtually silent as to the many complexities involved in implementing the mutual agreement procedures, the proposed treaty is very extensive. Several of the uncertainties that have developed over the years with respect to the implementation of the mutual agreement procedures, such as statute barriers, time for submission of competent authority requests, local law barriers, and the like, are specifically addressed in the proposed treaty. When effective, the existence of these specific terms should provide taxpayers with greater comfort in invoking the competent authority relief measures. In addition, this may contribute to a greater use of the competent authority procedures in attempting to provide relief from double taxation.

VI. SUMMARY

Despite various criticisms of the competent authority mechanism and, therefore, the apparent justification by many for not using the procedure, it is viewed as being effective in minimizing the element of double taxation of nationals of the United States and Canada. As noted previously, the greatest experience in utilizing the competent authority procedures as outlined in the treaties has existed with respect to nationals of the United States and Canada. It is obvious that the cooperation that has developed between the countries in carrying out the intent of the treaty has permitted the countries to join together in more ambitious efforts to curtail perceived abuses in cross-border transactions through the exchange of information programs and the simultaneous examination programs.

APPENDIX

TABLE A

COMPETENT AUTHORITY CASE STATISTICS

<u>Fiscal Year</u>	<u>Total Cases Received and Disposed Of</u>			
	<u>Total Cases Received</u>	<u>Total Cases Disposed of</u>	<u>Year-End Inventory</u>	<u>Average Duration</u>
1971	41	34	28	15.73 Months
1972	24	19	33	16.89
1973	36	18	51	17.22
1974	53	48	56	16.00
1975	51	37	70	15.05
1976	56	39	87	19.53
Trans.	12	10	89	13.20
1977	80	50	119	16.62
1978	57	25	151	21.84
1979	42	63	130	26.63
1980	100	65	165	23.68
1981	77	55	187	26.45
1982	96	90	193	25.60
1983	<u>83</u>	<u>109</u>	167	20.82
Total	808	662		

TABLE B

COMPETENT AUTHORITY CASE STATISTICSAllocation Cases Under Revenue Procedure 70-18

<u>Fiscal Year</u>	<u>Total Cases</u>	<u>U.S./Foreign Initiated</u>	
1971	27	14	13
1972	12	6	6
1973	23	16	7
1974	34	25	9
1975	39	29	10
1976	28	18	10
Trans.	6	5	1
1977	45	33	12
1978	42	30	12
1979	28	20	8
1980	60	37	23
1981	50	24	26
1982	67	40	27
1983	<u>53</u>	<u>20</u>	<u>34</u>
Total	514	317	198

TABLE C

COMPETENT AUTHORITY CASE STATISTICSDisposition of Allocation Cases Submitted Under
Revenue Procedure 70-18 and 82-29

<u>Fiscal Year</u>	<u>Total Dispositions</u>	<u>After Negotiations</u>			<u>Without Negotiations</u>		
		<u>Full Relief</u>	<u>Partial Relief</u>	<u>No Relief</u>	<u>Full Relief</u>	<u>Partial Relief</u>	<u>No Relief</u>
1971	11	6			4		1
1972	9	8			1		
1973	11	8		1			2
1974	28	19	3	2	1		3
1975	26	12	1		7		6
1976	25	15	4	2	1		3
Trans.	5	4					1
1977	22	9	2	1	3	1	6
1978	13	9			3		1
1979	38	27	1	1	2		7
1980	30	18	1	2	4		5
1981	37	21	2	4	2		8
1982	64	43	4	6	4		7
1983	<u>79</u>	<u>37</u>	<u>15</u>	<u>3</u>	<u> </u>	<u> </u>	<u>24</u>
Total	398	236	33	22	32	1	74

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