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TRAWLING FOR TAXPAYERS: SECTION 6038A AND TRANSFER PRICING REGULATIONS

The author takes exception with recently enacted transfer pricing rules. He concludes that the sweeping reporting requirements imposed on foreign controlled domestic corporations could be detrimental to both foreign relations and foreign investment in the United States. He, therefore, suggests options to avert these effects.

I. INTRODUCTION

Section 482 of the Internal Revenue Code (I.R.C.) grants the Internal Revenue Service (I.R.S.) the power to allocate income between two or more businesses owned or controlled by the same interests if allocation is necessary to prevent evasion of taxes. \(^1\) Section 482 seeks to prevent both foreign and domestic businesses from shifting income out of domestic \(^2\) businesses to related businesses in other countries through a process called transfer pricing. \(^3\)

Recently the I.R.S. has directed its attention to foreign corporations that have subsidiaries or branches in the United States. Since 1985, estimates of the amount of unpaid taxes the United States could recover from foreign corporations have reached fifty billion dollars. \(^4\) However, foreign corporations have resisted I.R.S. attempts to obtain the information necessary to calculate income allocations. They have been hesitant to turn over their books and records to the I.R.S., and thus, the I.R.S. had to resort to protract-

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2. For purposes of this note, the terms "domestic" and "United States" will be used interchangably.
3. Transfer pricing refers to the prices one division of a company charges another for products transferred between the divisions. RALPH L. BENKE JR. & JAMES D. EDWARDS, TRANSFER PRICING: TECHNIQUES AND USES 5 (1981).
ed litigation to obtain the needed information. Sections 6038A and 6038C were added to the Internal Revenue Code in 1982 and 1990, respectively, to compel foreign corporations with branches or subsidiaries in the United States to maintain and submit the required records to the I.R.S. for purposes of calculating section 482 allocations.

This note first discusses the general problem of foreign corporations' avoidance of U.S. tax obligations. Next, it discusses reporting requirements imposed under sections 6038A and 6038C and I.R.S. attempts to curb tax avoidance by foreign corporations through transfer pricing. The reporting requirements are analyzed in light of the purposes behind their adoption and their effect on foreign corporations, I.R.S. procedures, existing tax treaties and U.S. notions of fair play and substantial justice. This note concludes that the new legislation falls short of reaching its goals, while it imposes high reporting and jurisdictional burdens on foreign corporations without regard to any showing of culpability.

The need to enforce U.S. tax policy is undeniable. However, sections 6038A and 6038C merely add another patch to the leaking dike of U.S. tax avoidance. Accordingly, this note argues that the I.R.S. should adopt a threshold test to identify those foreign corporations that have a high probability of engaging in U.S. tax avoidance through transfer pricing. Under the proposed test, the reporting requirements under sections 6038A and 6038C would be imposed only on corporations that meet certain threshold criteria. Once the threshold test has been met, the United States would be deemed to have shown a substantial interest in obtaining the records, thus justifying the Service's imposition of the added reporting burdens on the foreign corporation.

II. PROBLEMS OF U.S. TAX AVOIDANCE

A. Treatment of Foreign Taxpayers in General

General authority to tax corporations is conferred by section

5. See infra text accompanying notes 54-76.
7. See infra Section II.
8. See infra Section III.
9. See infra Section IV.
11 of the I.R.C., but this authority is limited by sections 881 and 882 when a foreign corporation is involved.\textsuperscript{10} While a U.S. corporation is taxed on its worldwide income, the I.R.C. taxes only two types of foreign corporation income: “effectively connected” income, which is income “effectively connected with the conduct of a trade or business within the United States,”\textsuperscript{11} and U.S. source income, such as interest and dividends received from sources within the United States.\textsuperscript{12} To be “effectively connected,” the income must be from the United States and of a type enumerated in the I.R.C.\textsuperscript{13} Foreign corporations use transfer pricing to avoid taxation by shifting revenue from taxable “effectively connected” income to non-taxable, unconnected income.

\section*{B. Avoidance of U.S. Taxation via Transfer Pricing}

\subsection*{1. Transfer Pricing}

When goods are transferred between commonly owned or controlled corporations, the price charged and paid for those goods is denoted the “transfer price.”\textsuperscript{14} Transfer pricing encompasses all forms of transactions, from the sale of goods and services to the licensing of patents. Corporations have used this pricing method to divert income from one related company to another in order to reduce the tax liability of the combined corporation.\textsuperscript{15} The corporation usually shifts income from a branch or subsidiary in the United States to a branch or subsidiary in a country which imposes little or no tax liability, commonly called a “tax haven.”

\begin{enumerate}
\item I.R.C. § 864(c)(1) (providing the general rule to determine whether income is effectively connected).
\item Id. § 881(a) (detailing taxable income of foreign corporations not connected with a U.S. business).
\item \textit{Id.} § 864(c). With few exceptions, if a foreign corporation is engaged in a trade or business in the United States or has a place of business in the United States, most of its income will be effectively connected with a U.S. business. \textit{See id.} The determination of whether a foreign corporation is engaged in a U.S. trade or business is a question of fact dependent on the nature and extent of the corporation’s economic activity in the United States. Sarafopoulos, supra note 10, at § I(C).
\item \textit{See supra} note 3.
\item BENKE & EDWARDS, \textit{supra} note 3, at 5. For example, if Corp. A was operating at a loss and Corp. B was operating at a profit, the combined corporation could reduce its tax liability if Corp. B diverted income to Corp. A where the income would be completely offset by the loss.
\end{enumerate}
Tax avoidance through transfer pricing usually occurs in one of two ways. First, a U.S. parent company owning subsidiaries or branches in another country could sell its goods to the subsidiary or branch at a reduced price. This transaction would lower the expenses and raise the income of the subsidiary while lowering the income of the U.S. parent. In turn, reduction of the parent corporation's income lowers its U.S. tax liability. Second, a foreign parent corporation with a branch or subsidiary in the United States could charge a higher than normal price for goods sold to its U.S. counterparts. This transaction increases the income to the foreign parent while decreasing income and increasing expenses to the U.S. subsidiary or branch. Again, the effect is to lower the total U.S. tax liability.

This note focuses on the latter method of transfer pricing just described. For example, assume Eurosteel is a foreign corporation with a U.S. subsidiary called Domicorp. Eurosteel sells widgets in the United States to both Domicorp and Indcorp, an unrelated corporation. Eurosteel sells widgets to Domicorp for $500, but it sells the same widgets to Indcorp for $300, the maximum price Eurosteel can demand on the open market. If both Domicorp and Indcorp sell the widgets to U.S. consumers for $600, Domicorp would make a profit of $100 while Indcorp would make $300 per widget. The $200 profit Domicorp would have made on each widget if it purchased the widget at market price is diverted to Eurosteel via the inflated price charged Domicorp. Eurosteel and Domicorp as a whole made the same amount of profit they would have made had Eurosteel sold the widgets to Domicorp at market price. However, instead of Eurosteel being taxed by the United States on $300 of income, it is taxed by the United States on only $100 of income. The $200 is considered to be income earned by Eurosteel outside of the United States.

2. The Extent of the Problem

The extent of the transfer pricing problem has been widely debated. In 1990, the House Ways and Means Oversight Subcommittee ("Subcommittee") conducted investigations into transfer pricing. The I.R.S. reported that in 1986, foreign-owned corpora-

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16. For purposes of this note, the country of the parent's incorporation is irrelevant because the specific reasons a foreign parent transfers income out of the United States are not pertinent to the discussion at hand.
17. See Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings
tions had gross sales of $550 billion in the United States, but they reported negative taxable incomes of $1.5 billion. In addition, I.R.S. statistics show that in 1987, the return on assets and return on receipts for all foreign corporations was less than one percent, whereas similar returns for comparable U.S. corporations reached eight percent.

The Subcommittee's investigation focused on an analysis of the income statements of thirty-six foreign-owned domestic distributors of automobiles, motorcycles and electronics equipment over a ten-year period. The subjects were incorporated in the United States and distributed foreign-made products to American wholesalers and retailers. Of the thirty-six companies in the study, "25 were from Pacific Rim Countries and 11 were controlled by European parent companies." Over the ten-year period, the eighteen electronics distributors paid one half of one percent of their gross receipts in taxes. In 1987, these companies paid less than two tenths of one percent. The eighteen automobile and motorcycle companies paid slightly less than one percent of gross revenues in income tax in 1987. However, because these figures do not take into account operating loss carrybacks and carryforwards, the actual amount paid in taxes will be even lower than the statistics suggest. For example, over a ten-year period, one foreign company

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21. Id.
22. Id. at 42-43 (statement of Patrick G. Heck, Assistant Counsel, Subcomm. on Oversight); see also 136 CONG. REC. at H4527 (statement of Rep. Filippo). The Subcommittee examined 106 tax returns from 18 electronics distributors. In 1987, 14 of the 18 companies had $20 billion in gross receipts, but paid only $38 million in taxes. Eight companies reported almost $14 billion in gross receipts, yet paid no taxes. Id.
24. Id. at 43.
25. Id.
operating in the United States had gross receipts exceeding $3.5 billion and gross profits of $600 million, yet paid only $500 in U.S. taxes.\(^{26}\) The Subcommittee attributed the low tax liabilities to transfer pricing violations and, on the advice of the I.R.S., estimated the loss of U.S. tax revenue to be between thirteen and fifty billion dollars.\(^{27}\)

Specific examples of transfer pricing violations were cited in the Subcommittee hearing.\(^{28}\) For example, a foreign parent sold televisions to its U.S. subsidiary for $250 while it sold identical models to an unrelated corporation for $150.\(^{29}\) In another example, a foreign automobile manufacturer sold cars to its U.S. subsidiary distributors for $800 more than it charged Canadian distributors.\(^{30}\)

A second study was conducted for the Organization for Fair Treatment of International Investments ("OFTII") by KPMG Peat Marwick, an international accounting firm.\(^{31}\) Using publicly available I.R.S. Statistics of Income data, KPMG tracked effective tax rates for foreign-owned companies based on assets, net worth and positive net income from 1983 to 1986.\(^{32}\) The study found that on average, foreign-owned companies paid a higher effective tax rate than U.S. companies.\(^{33}\) However, the study conceded that this effective rate was the average from 1983 to 1986, and that the tax rate for foreign firms actually fell between 1985 and 1986.\(^{34}\) Three possible explanations were given for the low tax liability of foreign-controlled domestic corporations ("FCDC") in 1986: (1) high depreciation and amortization deductions from start-up expenses; (2) high debt expense due to acquiring ongoing business; and

\(^{26}\) 136 CONG. REC. at H4525 (statement of Rep. Pickle). The $500 was paid in one year, with losses declared in the other nine years investigated in the study. \(\text{Id.}\)

\(^{27}\) Hearings, supra note 17, at 62 (statement of Rep. Pickle). While the I.R.S. expressed reservations that the estimate might be on the high side, it acknowledged the loss was in the billions of dollars. \(\text{Id.}\) (statement of Mr. Fred T. Goldberg, Commissioner of the I.R.S.).

\(^{28}\) Hearings, supra note 17, at 43 (statement of Mr. Heck).

\(^{29}\) \(\text{Id.}\)

\(^{30}\) \(\text{Id.}\)


\(^{32}\) \(\text{Id.}\)

\(^{33}\) \(\text{Id.}\)

\(^{34}\) \(\text{Id.}\) at 29. I.R.S. data were not available in sufficient quantities to explain the reasons for the decline.
(3) high intercompany prices for goods and services.\textsuperscript{35}

Because the OFTII study concluded that the effective tax rate for foreign-owned companies was higher than that of domestic companies from 1983 to 1986, the subcommittee and OFTII studies apparently could be used to support opposing positions on the question of whether foreign companies are avoiding U.S. taxation through transfer pricing. However, these studies are not necessarily in conflict.

The Subcommittee study focused on thirty-six companies that were distributors of automobiles, motorcycles and electronic equipment.\textsuperscript{36} This sample is hardly representative of FCDCs; in 1982, domestic corporations controlled by a foreign entity filed 35,833 returns with the I.R.S. and foreign corporations with U.S. source income filed 10,661 returns.\textsuperscript{37} The Subcommittee study’s sample includes approximately one-tenth of one percent of the corporations filing returns. In addition, although the I.R.S. breaks down income statistics into eight primary categories and nine subcategories of industries,\textsuperscript{38} the Subcommittee’s sample would fit within only one of those subcategories. Thus, the Subcommittee study’s results may be an appropriate and accurate analysis of the companies included, but the results are not necessarily indicative of the tax treatment of FCDCs as a whole. Surely this study should not be used as a basis for sweeping legislation that would substantially affect all FCDCs and their parent corporations.\textsuperscript{39}

By comparison, the OFTII study, based on a sampling of all FCDCs, is more indicative of the tax treatment of FCDCs in general.\textsuperscript{40} However, this study should not be taken as the definitive answer to the existence of transfer pricing abuse. First, although the study cites transfer pricing violations as one explanation for the

\textsuperscript{35} Id. at 23. Note that the third explanation is contrary to the position of those who urge fewer restrictions on FCDCs.

\textsuperscript{36} See supra notes 20-32 and accompanying text for a description of the subcommittee sample group and findings.


\textsuperscript{38} Id. at 316-17. The eight categories of industries are agriculture, forestry and fishing; mining; construction; manufacturing; transportation and public utilities; wholesale and retail trade; finance, insurance, and real estate; and, services. Id. The subcategories are based on geographical location. Id.

\textsuperscript{39} Hearings, supra note 17, at 447 (statement of James Merle Carter, Secretary of OFTII).

\textsuperscript{40} See supra text accompanying note 34.
decline in FCDC effective tax rates, two other viable explanations that do not involve transfer pricing violations exist.\footnote{41} Second, due to the decrease in effective tax rates from 1985 to 1986, it is possible to infer that this study illustrates a trend toward lower tax liability for foreign corporations. Furthermore, even though it may be assumed, due to the large number of FCDCs, that some commit transfer pricing violations, the study is too general to draw conclusions about the extent of the problem in specific industries.\footnote{42}

Taken together, these studies show that transfer pricing is used by some foreign corporations to avoid U.S. taxation, but they suggest this abuse is not widespread. Rather, the abuse is most likely limited to specific industries or specific companies within a given industry. Thus, transfer pricing regulations under section 482 should be drafted to impose additional burdens only on those companies that have shown a propensity to avoid U.S. taxation through transfer pricing.\footnote{43}

C. Section 482 and I.R.S. Attempts to Allocate Income

Section 482 is the I.R.S.'s response to U.S. tax avoidance via transfer pricing. Section 482 authorizes the I.R.S. to adjust transactions between related entities so that the terms of the transaction are what they would have been if the parties had been unrelated.\footnote{44} The goal of section 482 is to put the controlled taxpayer in the same position with respect to income and deductions in any

\footnote{41} See supra text accompanying note 37.
\footnote{42} See KPMG PEAT MARWICK, supra note 31, at 30.
\footnote{43} See infra part IV.
\footnote{44} I.R.C. § 482. Section 482 provides:

In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

\textit{Id.} See also Treas. Reg. § 1.482-1 (as amended in 1968).

The effects of § 482 are sweeping and exceed the scope of this note. Section 482 applies "to any combination of entities, so long as the required element of control is present." 2 RUPUS VON THULEN RHOADES & MARSHALL J. LANGER, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 7.11(2), at 7-108 (1992).
given transaction as the uncontrolled taxpayer.\textsuperscript{45} Pursuant to section 482, the I.R.S. may apportion income, deductions, credits and allowances between two or more businesses owned or controlled by the same interest if the I.R.S. determines the apportionment is necessary to prevent evasion of taxes.\textsuperscript{46}

Foreign corporations with U.S. subsidiaries present a unique problem for enforcement of section 482 because the I.R.S. is often unable to obtain pricing information pertaining to transactions between the foreign corporation and its U.S. branch or subsidiary.\textsuperscript{47} This information is vital to I.R.S. assessment of whether transfer pricing violations have occurred.\textsuperscript{48} There are three methods currently available to the I.R.S. for obtaining this information other than the reporting requirements of sections 6038A and 6038C.

1. Tax Treaties

Existing tax treaties provide the I.R.S. a potentially useful tool for obtaining the documents necessary to reallocate income. The United States has tax treaties with approximately fifty countries, encompassing most of western Europe and the Pacific.\textsuperscript{49} All but one of these treaties contains an exchange of information provision.\textsuperscript{50} In general, such a provision gives the I.R.S. access to in-

\textsuperscript{45} Treas. Reg. § 1.482-1(b). As used in § 482, the term "controlled" includes "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise." Treas Reg. § 1.482-1(a)(3). Control can vest in more than one person or entity, whether or not they are related. "If a number of persons jointly dominate the entities, those persons jointly control the entities." ROADES & LANGER, supra, § 7.11[3], at 7-109 (citing Idaho Livestock Auction, Inc. v. United States, 187 F. Supp. 875 (D. Idaho 1960)).

\textsuperscript{46} I.R.C. § 482. See Raymond P. Wexler et al., Effective Application of the Section 482 Transfer Pricing Regulations, 42 TAX L. REV. 295, 300-04 (1987) (noting the I.R.S.'s vital interest in controlling income shifting between related foreign and domestic entities). This note is limited to the application of § 482 to foreign companies with U.S. subsidiaries and branches.


\textsuperscript{48} The "arms length transaction" standard is the generally accepted method for determining whether transfer pricing violations have occurred. An arms length price is the "price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arms length price normally involves a profit to the seller." Treas. Reg. § 1.482-2(e)(1)(i) (1991).

\textsuperscript{49} Paula M. Junghans, Foreign Documents in U.S. Tax Examinations, 47 INST. ON FED. TAX'N §§ 54.01, 54.08, at 54-22 (1989).

\textsuperscript{50} The tax treaty with the former Soviet Union is the only one without an exchange
formation needed to prevent tax frauds or enforce provisions of the treaty.\textsuperscript{51}

Information exchange provisions are limited to information relevant to tax matters. The I.R.S. can obtain five types of information under these treaty provisions.\textsuperscript{52} First, each treaty partner agrees to notify the other of any changes in its tax laws, making it easier for the parties to enforce the treaty provisions.\textsuperscript{53} Second, the treaty partners routinely exchange information relating to income subject to withholding in the participating countries.\textsuperscript{54} Third, information discovered by one treaty partner during a tax examination suggesting noncompliance with another treaty partner's tax laws is automatically given by the discovering partner to the other partner.\textsuperscript{55} The fourth and most useful type of information available under existing treaties is specific requests for exchange of information. Each request is considered separately to determine whether it is appropriate to comply with the request. The treaty partners consider factors such as administrative practicality, protection of the persons involved, public policy and appropriate use of the information by the receiving party before granting the request.\textsuperscript{56} The fifth type of information is industry-wide exchanges of information. This information provides treaty partners with comprehensive data on worldwide industry practices and promotes an understanding of international industries.\textsuperscript{57}

As illustrated, a wide range of information is available through treaty information exchange provisions. In general, however, the procedures required to obtain the information are more time-consuming and limiting than the I.R.S. International Examiners believe is necessary to be effective. Thus, information exchange provisions

\textsuperscript{51} Id.

\textsuperscript{52} U.S. Treasury Model Convention, May 17, 1977, \textit{reprinted in} \textbf{PRACTICING LAW INSTITUTE, INCOME TAX TREATIES} ( Jon E. Bischel, ed., 1978) [hereinafter 1977 Model Treaty]. The 1977 Model Treaty is the basis for most tax treaties in effect. However, due to the negotiations involved in adopting a tax treaty, each treaty will be slightly different, and all of the principles discussed in the text may not apply to every tax treaty in effect.

\textsuperscript{53} Id. at art. 2, § 3.

\textsuperscript{54} 402-2d \textit{TAX MGMT. (BNA) § V(B)(2)(d), at A-35 (Oct. 23, 1989).}

\textsuperscript{55} Id. § V(B)(2)(e), at A-36.

\textsuperscript{56} Id. § V(B)(2)(f), at A-36.

\textsuperscript{57} Id. § V(B)(2)(g), at A-37.
are not often used.\textsuperscript{58}

2. Administrative Summons

The second and most common method of obtaining pricing information is an administrative summons requiring a foreign parent to turn over documentation relating to transactions with its U.S. subsidiary.\textsuperscript{59} Use of the administrative summons was litigated in United States v. Toyota Motor Corp. (Toyota I).\textsuperscript{60} In Toyota I, Toyota sought dismissal of an I.R.S. summons served on the Toyota Motor Corporation, a Japanese corporation, (Toyota Japan) to obtain documents relating to transactions with its U.S. subsidiary (Toyota U.S.) to determine the tax liability of Toyota U.S.\textsuperscript{61} The United States District Court for the Central District of California held that the I.R.S. had jurisdiction to issue the summons and that the summons was properly served.\textsuperscript{62}

The I.R.S. must have personal jurisdiction over the foreign parent corporation in order to properly use its authority to issue a summons.\textsuperscript{63} The court held that personal jurisdiction was conferred by the I.R.C. because Toyota Japan could be "found" in the Central District of California.\textsuperscript{64} However, the grant of personal jurisdiction must also be consistent with the due process limitations of the Fifth Amendment.\textsuperscript{65} The court used the purposeful availment test to determine whether such a grant was constitution-

\textsuperscript{58} INTERCOMPANY PRICING RULES, \textit{supra} note 47, at 43,526.
\textsuperscript{59} I.R.C. § 7602. Section 7602 gives the I.R.S. the general authority to examine books, records, papers or other data to determine the correctness of any return or the tax liability of any person. \textit{Id.} § 7602(a)(1). In addition, the I.R.S. may issue summonses to require persons liable or persons with information about the liability of another to appear before the Secretary to give testimony. \textit{Id.} § 7602(a)(2).
\textsuperscript{60} 561 F. Supp. 354 (C.D. Cal. 1983).
\textsuperscript{61} \textit{Id.}
\textsuperscript{62} \textit{Id.} at 360-61.
\textsuperscript{63} \textit{Id.} at 357.
\textsuperscript{64} \textit{Id.} at 357-58. The court ruled that jurisdiction should be granted to the extent of the summons power authorized by § 7602. \textit{Id.} Section 7602 authorizes the I.R.S. to issue a summons for almost any person with information on tax liability or with any books or records. I.R.C. § 7602.
\textsuperscript{65} Enforcement of a summons is authorized by I.R.C. § 7402 and I.R.C. § 7604. Both enforcement provisions grant jurisdiction to the United States district court for the district in which the subject of the summons resides or is found. I.R.C. §§ 7402(b), 7604(a). Following appropriate procedure, the district court is directed to compel compliance with the summons. \textit{Id.}
\textsuperscript{66} \textit{Toyota I}, 561 F. Supp. at 359-60.
al.66 Under this test, personal jurisdiction is consistent with due process if the "corporation . . . delivers its products into the stream of commerce with the expectation that they will be purchased by consumers in the forum State."67 The court recognized that mere ownership of a subsidiary in the forum state was not sufficient to automatically confer jurisdiction over the parent.68 However, the court found that Toyota U.S was nothing more than a marketing conduit for Toyota Japan and that significant overlap existed between the senior management and board of directors of the parent and the subsidiary.69 Based on these circumstances, the court found that its exercise of personal jurisdiction over Toyota Japan was consistent with the Fifth Amendment due process limitations.70

Toyota also challenged the process by which the I.R.S. served the summons on Toyota Japan. Following precedent, the district court concluded that the agent for service of process is that entity in charge of the activities that justified the exercise of personal jurisdiction over the defendant.71

Toyota 1 was followed by United States v. Toyota Motor Corp. (Toyota 2)72 in which the same court determined the enforceability of the summons at issue in Toyota 1. The district court found that service of the summons satisfied the requirements of the I.R.C., although for slightly different reasons than those enumerated in Toyota 1.73 The court examined whether the summons itself met the requirements of the I.R.C.74 and the principles of international law.75 International law allows courts to order the produc-

66. Id. at 359.
67. Id. (quoting World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297-98 (1980)).
68. Id. (citing Cannon Mfg. Co. v. Cudahy Packing Co., 267 U.S 333 (1925), overruled by Int'l Shoe Co. v. Washington, 326 U.S. 310 (1945)).
69. Id. at 356.
70. Id. at 359.
71. Id. at 361 (citing Kupetoris v. Konkar Intrepid Corp., 402 F. Supp. 951 (S.D.N.Y. 1975), aff'd, 535 F.2d 1392 (2d Cir. 1976)).
73. Id. at 1160-61; see Toyota 1, 561 F. Supp. at 361.
74. I.R.C. § 7603 provides in pertinent part:
   A summons issued under section . . . 7602 shall be served by the Secretary, by an attested copy delivered in hand to the person to whom it is directed, or left at his last and usual place of abode . . . . When the summons requires the production of books, papers, records, or other data, it shall be sufficient if such books, papers, records, or other data are described with reasonable certainty.
75. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES
tion of foreign documents only when the documents are directly relevant, necessary and material to an investigation by a government agency.76

The first portion of the I.R.S. summons at issue in Toyota 2 was the request that Toyota Japan “[p]rovide all orders, directives, instructions, commands, and regulations issued to Toyota Motor Sales, U.S.A., Inc. by Toyota Motor Co., Ltd., and Toyota Motor Sales Co., Ltd. for each of the fiscal years 1975, 1976, 1977, and 1978.”77 The court held this request could not be enforced as written because it did not meet the “reasonable certainty” requirement found in I.R.C. section 7603.78 The court also denied efforts by the I.R.S. to narrow the summons and limit the request to the “production of orders and directives (1) dictating pricing policies and (2) relating to matters that ‘affect’ pricing” because the court had no practical means of modifying the summons even though the court was authorized to do so.79

However, a second portion of the I.R.S. summons requesting that Toyota Japan “[p]rovide unit selling prices, including the price of spare tires and tools, to Japan dealers for each passenger car model sold during each of the fiscal years 1976, 1977 and 1978” was upheld.80 The court applied a balancing test consisting of five factors to determine whether the documents and other information requested were directly relevant, necessary and material to an investigation.81 The five factors include:

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§ 442(1)(a) (1986). In Toyota 2, the court relied on an earlier version of the Restatement. Toyota 2, 569 F. Supp. at 1162 (citing Restatement (Revised) of the Foreign Relations Law of the United States § 420(1)(a) (Tentative Draft No. 3, 1982)).

76. Id.
77. Toyota 2, 569 F. Supp. at 1161.
78. Id. See supra note 74 for the text of I.R.C. § 7603.

The requirement of “reasonable certainty” was well articulated in First Nat’l Bank of Mobile v. United States, 160 F.2d 532 (5th Cir. 1947), as follows:

We do not mean that the revenue agent must be able to describe in minute detail every document and paper that he wishes to inspect, but he must be able to describe them with such reasonable particularity that the [responding parties] will have sufficient information to enable them to produce such records for the inspection of the revenue agent.

Id. at 535 (citation omitted). The court stated that in matters of disputed tax liability, only those records pertaining to the actual individuals or entities involved and specifically needed to resolve the dispute must be produced. Id. at 533.

79. Toyota 2, 569 F. Supp. at 1161.
80. Id. at 1162.
81. Id. (citing Restatement (Revised) of the Foreign Relations Law of the United States § 420(1)(a), (c) (Tentative Draft No. 3, 1982) (codified as amended at Restatement (Third) of the Foreign Relations Law of the United States
the importance to the investigation or litigation of the documents or other information requested; the degree of specificity of the request; in which of the states involved the documents or information originated; the extent to which compliance with the request would undermine important interests of the state where the information is located; and the possibility of alternative means of securing the information.8

The court noted that when the documents requested are located in a foreign country, the information must be more closely scrutinized than if the summons had been issued for information located in the United States.83 In enforcing the summons, the court emphasized the importance of the information, the specificity of the summons and the unavailability of other methods to obtain the information.84

The process of issuing an administrative summons serves to protect the interests of the party supplying the documents by requiring the I.R.S. to establish both jurisdiction and need before obtaining the documentation. These requirements place a heavy burden on the I.R.S. and could lead to increased expense and protracted litigation. However, this burden is justified in order to protect the interests of a foreign party against the possibly unreasonable demands by the I.R.S.

3. Formal Document Request

The third method of obtaining pricing information from foreign corporations is a “formal document request.”85 A formal document request is a request made after “the normal request procedures have failed to produce the requested documentation.”86 If the party fails

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8. § 442(1)(a), (c) (1986)).
82. Id.
83. Id.
84. Id. at 1162-63. However, the issue of whether the records of a corporate parent may be reached through its subsidiary is undecided. See In re Uranium Antitrust Litigation, 480 F. Supp. 1138, 1145 (N.D. Ill. 1979).
85. I.R.C. § 982.
86. Id. § 982(c)(1). A formal document request seeks the production of foreign-based documents. It must be mailed by registered or certified mail. In addition, it should set forth the following: “(A) the time and place for the production of the documentation, (B) a statement of the reason the documentation previously produced (if any) is not sufficient,
to comply with the formal document request, the I.R.S. can prohibit the party from introducing the requested documentation into the tax assessment process at a later date. However, the I.R.S. will not invoke this "exclusionary rule" if the taxpayer shows reasonable cause for not producing the documentation. The exclusionary rule is a powerful inducement for taxpayers to turn over the requested documentation.

Formal document requests do have drawbacks. First, the entire process, from the initial issuance of the administrative summons to the final assessment after the exclusionary rule has been invoked, can be expensive and time-consuming for an already understaffed group of international tax examiners. In addition, the I.R.S. has an important interest in maintaining good working relationships with taxpayers and, therefore, may choose not to exercise its full discretion in issuing document requests.

III. THE NEW LEGISLATION: REPORTING REQUIREMENTS OF SECTIONS 6038A AND 6038C

Three major problems frustrated the I.R.S.'s efforts to obtain foreign-based documentation through the use of tax treaties, administrative summons and formal document requests. The first and most common problem was the significant length of time required to both administer the chosen method, and defend its use if the foreign party challenged the authority of the I.R.S. Second, the I.R.S. has had difficulty establishing jurisdiction over foreign par-

(C) a description of the documentation being sought, and
(D) the consequences to the taxpayer of the failure to produce the documentation."

Id. § 982(c)(1)(A)-(D)

87. Id. § 982(a). "If the taxpayer fails to substantially comply with any formal document request . . . any court having jurisdiction . . . shall prohibit the introduction by the taxpayer of any foreign-based documentation covered by such a request." Id. Foreign-based documentation includes "any documentation which is outside the United States and which may be relevant or material to the tax treatment of the examined item." Id. § 982(d)(1).

88. Id. § 982(b)(1). Compliance with foreign nondisclosure laws is not sufficient in and of itself to constitute reasonable cause. Id. § 982(b)(2).

89. It should be noted that courts have not yet used this power. See Flying Tigers Oil Co. v. Commissioner, 92 T.C. 1261, 1265 (1989) ("This court has never before specifically applied the 'exclusion rule' of section 982.").

90. INTERCOMPANY PRICING RULES, supra note 47, at 43,526.

91. Id.

92. See Richard A. Gordon et al., Information Reporting for Foreign-Owned Corporations (The Proposed Section 6038A Regulations) — The Inside Story, 60 TAX NOTES 1125, 1127-28 (1991), for a full discussion of the problems the 1989 amendments to § 6038A were intended to address.
ties.\textsuperscript{93} Third, the I.R.S. incurs an added expense trying to prove their case in a timely manner, as seen in \textit{Toyota 1} and \textit{Toyota 2}.\textsuperscript{94} In response to these problems, Congress enacted sections 6038A and 6038C in an attempt to preempt challenges to jurisdiction and I.R.S. authority and to solve problems related to lengthy litigation.\textsuperscript{95}

A. Purpose of the New Legislation

Congress enacted sections 6038A and 6038C in 1982 and 1990, respectively, to facilitate I.R.S. efforts to obtain transfer pricing information from foreign corporations with branches or subsidiaries in the United States.\textsuperscript{96} This pricing information is necessary to aid the I.R.S. in calculating income allocations between related entities under section 482 and in ensuring that all corporations pay U.S. taxes on income attributable to U.S. sources. Sections 6038A and 6038C apply to corporations that qualify as "reporting corporations."\textsuperscript{97} Section 6038A applies to domestic subsidiaries of foreign corporations, and it denotes a U.S. corporation a "reporting corporation" if, at any time during the taxable year, the corporation has one or more foreign shareholders that own at least a twenty-five percent interest in the corporation.\textsuperscript{98} Section 6038C applies to domestic branches of foreign corporation.\textsuperscript{99} For purposes of section 6038C, a reporting corporation is a foreign corporation engaged in a trade or business within the United States.\textsuperscript{100}

Once a corporation is deemed a reporting corporation under section 6038A or 6038C, it must satisfy the reporting requirements under the regulations to section 6038A.\textsuperscript{101} In addition, section 6038C requires the corporation to submit "such other information

\textsuperscript{93} \textit{Id.}
\textsuperscript{94} See supra section II.C.2.
\textsuperscript{95} See \textit{JOINT COMM. EXPLANATION}, supra note 6, at 250 (regarding congressional intent in enacting § 6038A). Section 6038C was enacted to fill the gaps left by § 6038A.
\textsuperscript{96} See I.R.C. §§ 6038A, 6038C; \textit{JOINT COMM. EXPLANATION}, supra note 6, at 250.
\textsuperscript{97} I.R.C. §§ 6038A, 6038C.
\textsuperscript{99} I.R.C. § 6038C(a).
\textsuperscript{100} \textit{Id.}
as the Secretary may prescribe by regulations relating to any item not directly connected with a transaction for which information is required under [section 6038A].” Foreign corporations can avoid the reporting requirements of either section 6038A or section 6038C if they meet the de minimis or small corporation exception set out in the regulations to section 6038A.

B. New Legislative Requirements

The new legislation sets out extensive reporting requirements for foreign corporations that have subsidiaries or branches within the United States. One set of regulations for section 6038A was finalized in 1989, but two months after adoption of the Omnibus Budget Reconciliation Act of 1990 (1990 Act), a new set of regulations for section 6038A was issued. These more recent regulations detail the reporting requirements for section 6038A. The proposed regulations reflect what the I.R.S. will focus on

102. I.R.C. § 6038C(b)(2). The Secretary's authority to require "other information" has the potential of imposing a wide variety of reporting burdens for foreign corporations. However, the section is too recent to accurately predict the extent of this additional burden.

The rest of the regulations for § 6038C will be substantially the same as those promulgated pursuant to 6038A except that the emphasis will be on allocation and apportionment of income within one entity, the foreign corporation and its U.S. branch, rather than between separate distinct entities. Telephone interview with Charles Plumbeck, I.R.S., (Jan. 18, 1990).

103. Treas. Reg. § 1.6038A-1(h). The de minimis exception applies a two-tiered test in exempting small foreign corporations from the reporting requirements of §§ 1.6038A-3 and 1.6038A-5, although the small corporation is still subject to the informational reporting requirements of § 1.6038A-2 and the general record maintenance requirements of § 6001. Treas. Reg. § 1.6038A-1(h). First, the reporting corporation must have an aggregate value of no more than $2 million of gross payments made to or received from foreign related parties with respect to related party transactions. Treas. Reg. § 1.6038A-1(h). Second, the aggregate value of these gross payments must be less than 10% of the foreign parties' U.S. gross income. Treas. Reg. § 1.6038A-1(h).

104. The purpose of this note is to give an overview of the 6038A regulations and propose solutions for the problems it creates. For a more detailed explanation of the 6038A legislatures, see John V. Pridjion, Using a Shotgun When a Pistol Would Do -- An Examination of the Information Reporting and Recordkeeping Requirements For Foreign Owned Corporations (Section 6038A Regulations), 11 VA. TAX REV. 427 (1991).


when enforcing the reporting requirements.

Reporting corporations, as described above, are required to maintain certain records necessary to determine the correct tax treatment of transactions with related parties. The records specified within section 6038A are records which would normally be required under the general recordkeeping provisions for all taxpayers. Section 6038A, together with the regulations, provides detailed guidance regarding the required maintenance of records with respect to transactions between the reporting corporation and foreign related parties and establishes specific penalties for noncompliance.

The types of records to be maintained are governed by several general rules. First, records that are either directly or indirectly related to transactions between reporting corporations and foreign related parties must be maintained. For example, these records could include pricing documentation of raw materials or component parts sold by a foreign subsidiary to the foreign parent and eventually resold to the reporting corporation. Second, as a general rule, the records must be maintained in the United States. Additionally, the records must be translated into English within 30 days of a request for the documentation.

In addition to the records themselves, the corporation must also maintain adequate internal storage and retrieval systems to enable

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107. See supra notes 97-100 and accompanying text.
108. I.R.C. §§ 6038A(a), 6038C(b)(1). Related parties are defined as:
   (A) any 25-percent foreign shareholder of the reporting corporation,
   (B) any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the reporting corporation or to a 25-percent foreign shareholder of the reporting corporation, and
   (C) any other person who is related (within the meaning of section 482) to the reporting corporation.
I.R.C. §§ 6038A(c)(2), 6038C(e).
109. See id. § 6001 (setting forth the general recordkeeping requirements).
110. Id. § 6038A(b)(3) & (d); Treas. Reg. § 1.6038A-3(a)(1). Cf. I.R.C. § 6001. Section 6001 establishes that all taxpayers are required to maintain certain records to allow the I.R.S. to determine the tax liability of the taxpayer.
111. Treas. Reg. §§ 1.6038A-3(a), (b).
112. Id. § 1.6038A-3(b)(1).
113. Id.
114. Id. § 1.6038A-3(f)(1). However, records may be maintained outside the United States if the reporting corporation either delivers the requested documentation to the I.R.S. within 60 days of the request or if the corporation moves the requested documents to the United States within 60 days of the I.R.S. request. Id. §§ 1.6038A-3(b)(2), (f)(2).
115. Id. § 1.6038A-3(b)(3).
the I.R.S. to locate relevant documents. While the regulations provide general descriptions of the kinds of records to be maintained, the record maintenance requirements can also be fulfilled by supplying the functional equivalents of the categories of records.

The six types of records to be maintained can be broken down into two categories, records that must be created and records that are normally maintained. The first category consists of basic accounting records and material profit and loss statements. The second category consists of pricing documents, foreign country and third party filings, ownership and capital structure records and records of non-sales transactions.

1. Records Which Must be Created

The first type of record within this category which must be kept is basic accounting records, including original entry books and transaction records relevant to transactions between the reporting corporation and its foreign related party. Records such as general ledgers, sales journals and contracts, work papers and cancelled checks are also included. Most corporations create some form of these documents in the ordinary course of business, making translation the records the heaviest burden.

The second type of record within this category includes records sufficient to compile material profit and loss statements of both the reporting corporation and all related parties. Absent an agreement between the District Director and the reporting corporation regarding the materiality of profit and loss statements, the regulations set out three tests to apply in determining which profit and loss statements are material and, thus, must be maintained.

116. Id. § 1.6038A-3(c)(1).
117. Id.
118. See generally id. § 1.6038A-3(c)(2).
119. Id. §§ 1.6038A-3(c)(3) (i)-(ii).
120. Id. §§ 1.6038A-3(c)(3) (iii)-(vi).
121. Id. § 1.6038A-3(c)(3)(i).
122. Id. § 1.6038A-3(c)(3)(ii).
123. Id. § 1.6038A-3(c)(3)(iii).
124. The three tests are the "existing records test," the "significant industry segment test" and the "high profit test." The existing records test is simple in that if the related parties normally create such a statement, then it is material and they are required to maintain it. Treas. Reg. § 1.3068A-3(c)(4). On the other hand, the significant industry segments test is satisfied only after meeting a "gross revenue test" and one of three "percentage tests." Id. § 1.3068A-3(c)(5). The high profit test involves meeting a "return on

However, creating and maintaining the profit and loss statements is time-consuming. The I.R.S. originally estimated that the average annual recordkeeping burden per recordkeeper is ten hours. However, other estimates range from thirty to one-hundred hours for small firms to two man-years for large firms. As an example of the time-consuming nature of maintaining these statements, a foreign company with U.S. subsidiaries dealing in only two products may require one man-year to comply with the material profit and loss record requirements alone.

2. Records Normally Maintained

A second category of records may need to be maintained to meet the regulation’s requirements. Any documents in this class ordinarily created by the corporation or, if not ordinarily created, actually created, must be maintained if they are relevant to transactions between the reporting corporation and the foreign related party. The first type of records in this category consist of all pricing documents used to determine the appropriate transfer price. This includes intercompany correspondence and documents relating to transactions with either related or unrelated parties that involve similar products. Second, the corporation must maintain foreign country and third party filings. These include any documents relevant to transactions between the reporting corporation and foreign related party that have been prepared for a foreign government, independent commission or financial institution.

The third type of records within this category are ownership and capital structure records that show the relationship between the

assets test” and a higher “gross revenue test.” Id. § 1.3068A-3(c)(6). The extraordinary detail of these tests exceeds the scope of this paper.


127. Id.

128. Treas. Reg. § 1.6038A-3(c)(1).

129. Id. § 1.6038A-3(c)(2)(iii). The regulations also provide an extensive, but not exhaustive, list of examples.

130. Id. § 1.6038A-3(c)(2)(iv).

131. Id.
reporting corporation and the foreign related parties. Finally, the reporting corporation must maintain records of loans, services and other non-sale transactions. This catchall provision covers all other transactions a reporting corporation may have with a foreign related corporation. It includes registration of patents and copyrights, lawsuits relating to transactions and loan and security agreements.

It is evident that the burden on foreign corporations for maintaining these records will be substantial. Furthermore, it will be difficult to decide exactly what records should be kept, particularly in the case of "material" profit and loss statements. Also, it appears that there are few limits to what the I.R.S. can require of the reporting corporations.

C. Agent Designation

Sections 6038A and 6038C require the foreign corporation to authorize the reporting corporation to be its agent for purposes of receiving and responding to an administrative summons with respect to documents and relevant testimony regarding transactions between the two parties. However, the reporting corporation is designated an agent solely for tax purposes and does not expose the foreign corporation to jurisdiction for any other purpose. Also, the agent designation does not cause the foreign party to be deemed to have a U.S. trade or business.

If the foreign related party fails to authorize an agent for these purposes, the I.R.S. can assess penalties. First, the I.R.S. has the authority to determine the amount of any deduction or cost to

132. Id. § 1.6038A-3(c)(2)(v).
133. Id. § 1.6038A-3(c)(2)(vi).
134. Id.
136. Id.
137. See I.R.C. §§ 6038A(e), 6038C(d); Treas. Reg. § 1.6038A-5(a). The I.R.S. has the authority to serve and enforce the summons. Id. § 1.6038A-5(d)(2). The general authority to issue an administrative summons is found in I.R.C. §§ 7602, 7603 and 7604. For a discussion of the administrative summons procedure, see supra part II. B.
139. Id.
140. I.R.C. §§ 6038A(e)(3), 6038C(d)(3); see also Treas. Reg. § 1.6038A-7 (imposing monetary penalties). For a discussion of the sanctions for a failure to designate a U.S. Agent, see Gordon et al., supra note 92, at 1140.
the reporting corporation of property acquired in a transaction with a foreign related party.\textsuperscript{141} The I.R.S. has sole discretion to calculate the assessment using only the information the I.R.S. has available.\textsuperscript{142} Second, the failure to designate an agent violates a yearly reporting requirement and results in monetary sanctions as well.\textsuperscript{143}

The penalties for not designating an agent are imposed on the reporting corporation, not the foreign related party. As a result, the effectiveness of the penalties in ensuring compliance is questionable.\textsuperscript{144} For example, a foreign corporation that is a twenty-five percent shareholder in the U.S. reporting corporation has some incentive to comply because any penalties imposed on the reporting corporation will filter down and eventually affect the foreign shareholder’s income. However, a foreign party that is merely related to the twenty-five percent shareholder has a very small interest in the U.S. reporting corporation because the foreign party’s income is not directly affected by the reporting corporation. Thus, the foreign party has little incentive to comply with the agency provisions.\textsuperscript{145}

The reporting requirements under sections 6038A and 6038C differ from other methods of obtaining foreign based documentation in two significant ways. First, the reporting requirements of section 6038A and 6038C eliminate the need for the I.R.S. to show a basis for jurisdiction as would be necessary for an administrative summons or a formal document request. Eliminating these lengthy judicial processes designed to establish personal jurisdiction facilitates I.R.S. efforts to obtain foreign documents.

Second, sections 6038A and 6038C were unilaterally enacted by the United States and provide no protection for foreign corporations against the imposition of unreasonable demands by the I.R.S. For example, although tax treaties to obtain foreign-based documentation do not require any specific showing before the documents are turned over to the United States, the treaties were mutually agreed upon by both countries. The use of treaty provisions to obtain information would most likely not unduly burden the affected corporations because the agencies within the foreign related

\begin{thebibliography}{99}
\bibitem{footnote1} I.R.C. §§ 6038A(e)(2)-(3), 6038C(d)(2)-(3).
\bibitem{footnote2} Id. §§ 6038A(e)(3), 6038C(d)(3).
\bibitem{footnote3} See infra part D.
\bibitem{footnote4} See Gordon et al., supra note 92, at 1145.
\bibitem{footnote5} Id.
\end{thebibliography}
party's country can be assumed to have protected the interests of the foreign country and the corporation when agreeing to the treaty. Because sections 6038A and 6038C were unilaterally enacted, they contain no such assurances of protection.

D. Sanctions for Noncompliance

Failure to designate an agent pursuant to sections 6038A and 6038C violates a yearly reporting requirement and results in monetary sanctions against the reporting corporation. The yearly reporting requirements require the reporting corporation to file certain forms reporting related transactions and to maintain proper records (collectively referred to as "required information"). If not, monetary penalties are imposed. The reporting corporation is fined $10,000 for each taxable year it fails to furnish the required information. The fine is limited to $10,000 per offense, but additional offenses occur if the reporting corporation does not comply with the request within ninety days after a notice of failure to report has been sent and additional penalties accrue every thirty days thereafter. Because each offense costs $10,000, the penalties can accrue quickly.

The I.R.S. has great power to determine the overall tax liability of the non-complying reporting corporation. The I.R.S. has the authority to assess deficiencies and determine the costs to the parties for the transaction in question if the reporting corporation continues noncompliance and fails to exercise its judicial remedies within ninety days after the I.R.S. has given notice of the noncompliance. The I.R.S. may rely exclusively on any information it may possess in order to assess a deficiency. Furthermore, the I.R.S.’s determinations are defeated only “by ‘clear and convincing evidence’ that the I.R.S. determination was made with ‘improper

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147. I.R.C. §§ 6038A(b)(1), 6038C(b)(1) (imposing general obligation to report information, including name, place of business, countries in which the business is organized). Section 6038C additionally imposes the obligation on reporting parties to provide information requested by the Secretary. Id. § 6038C(b)(2). The standard form used in reporting information regarding transactions between foreign-related parties and foreign owned U.S. corporations or foreign corporations engaged in U.S. trade or business is I.R.S. Form 5472 (Rev. Nov. 1990).
148. I.R.C. §§ 6038A(d), 6038C(e).
149. Id.
150. Id.
151. Id. §§ 6038A(e)(2), 6038C(d)(2).
motive,' or that it was 'clearly erroneous by reference to all reasonably credible interpretations or assumptions of facts.'

The I.R.S.'s power is limited only by a "reasonable cause" exception. This exception applies if the reporting corporation shows reasonable cause for its failure to comply. Additionally, if the reporting corporation is a small organization, the regulations require the I.R.S. to apply the reasonable cause exception liberally.

E. Areas of Concern in the New Legislation

The major problem with sections 6038A and 6038C is that they are overinclusive for their intended purpose. One cannot deny that the I.R.S. has the right to enforce U.S. tax policy and receive the amount of tax appropriate for the income earned in the United States. However, this sweeping legislation is analogous to catching a goldfish in a trawlers net. The chances of catching the goldfish are high, but in the process, many innocent fish will be killed.

The statistics and surveys presented on both sides of the "how bad are transfer pricing violations" debate illustrate the overinclusiveness of the legislation. One survey by the House Ways and Means Oversight Subcommittee ("Subcommittee") noted that in a select group of foreign-owned U.S. subsidiaries there was a large discrepancy between the amount of revenue earned and taxes paid. Yet, a more expansive survey conducted for the Organization for Fair Treatment of International Investments ("OFTII") claimed that foreign-owned U.S. corporations paid a higher effective tax rate than wholly-owned U.S. corporations. This leads to the conclusion that while there may be pockets of U.S. tax avoidance, the problem is not as widespread as the subcommittee's survey indicates. An OFTII spokesman summarized the Subcommittee's conclusion well when he expressed deep concern for the "sweeping generalizations about the level of tax compliance by all foreign-owned companies [based on] the examination

152. Warden, supra note 135, at 954 (quoting H.R. CONF. REP. NO. 386, 101st Cong., 1st Sess. 594 (1989)); see also Bausch & Lomb, Inc. v. Comm'r, 92 T.C. 525, 582 (1989) (noting that the Commissioner's § 482 determination "must be sustained absent a showing that he has abused his discretion").


154. Id. § 1.6038A-4(b)(2)(i).

155. See supra part II.B. for a full discussion of the surveys.

156. See supra text accompanying notes 20-32.

157. See supra text accompanying notes 33-37.
of 36 companies - less than one percent of all foreign-owned companies."\textsuperscript{158} He further stated that "[b]eyond the small sample size, the selection criteria for this group were clearly targeted toward a group of companies that the IRS [sic] has already targeted for audit . . . ."\textsuperscript{159}

In addition to being overbroad, the legislation effectively skirts jurisdictional issues. The I.R.S. has encountered problems when attempting to enforce summonses against foreign corporations with U.S. subsidiaries because it has been difficult to prove that U.S. courts had jurisdiction over the foreign parties.\textsuperscript{160} The courts have not developed a uniform test to determine when jurisdiction is proper. Rather, the courts rely on due process limitations which state that exercise of jurisdiction should coincide with notions of fair play and substantial justice.\textsuperscript{161} Indeed, jurisdiction should be determined on a case-by-case basis supported by the facts of each case, not by broad generalizations.

Sections 6038A and 6038C attempt to avoid the necessity of establishing jurisdiction on a case-by-case basis by requiring foreign corporations to authorize their U.S. subsidiaries and branches as agents for service of process. However, the rule established in \textit{Toyota I} is that U.S. subsidiaries are agents only after it is determined that the foreign parent is subject to personal jurisdiction.\textsuperscript{162} Thus, in order to establish an agency relationship, a court must first establish personal jurisdiction over the foreign party. Sections 6038A and 6038C attempt to bypass the necessity of establishing jurisdiction and, instead, automatically require the foreign party to name its U.S. subsidiary or branch as its agent without regard to the usual jurisdictional requirements. Because

\textsuperscript{158} \textit{Hearings, supra} note 17, at 446 (statement of James Merle Carter, Secretary of OFTII) (excerpts from testimony submitted by OFTII to the Subcommittee on Aug. 3, 1990).

\textsuperscript{159} Id.

\textsuperscript{160} See, e.g., \textit{In re Sealed Case}, 832 F.2d 1268, 1273 (D.C. Cir. 1987) (holding that federal courts have personal jurisdiction over foreign corporations, only if the corporation has the requisite "minimum contacts" with the United States); McClenon v. Nissan Motor Corp. in U.S.A., 726 F. Supp. 822, 830 (Fla. 1989) (finding direct service of process by mail upon Japanese defendant inadequate); United States v. Toyota Motor Corp. \textit{(Toyota 2)}, 559 F. Supp. 1158, 1162 (C.D. Cal. 1983) (ruling that an I.R.S. summons directed at documents located abroad must meet a more stringent test of "direct relevancy, necessity and materiality" than is required of comparable requests for documents located in the United States).

\textsuperscript{161} See supra text accompanying notes 65-72.

\textsuperscript{162} See United States v. Toyota Motor Corp., 561 F. Supp. 354 (C.D. Cal. 1983); see also supra text accompanying notes 65-72.
these sections avoid any judicial determination of jurisdiction, the potential for unreasonably burdening foreign parties is great.

These jurisdictional issues may affect provisions in U.S. tax treaties, although the impact of these sections on existing tax treaties is unclear. The treaty countries' major concern is the possible violation of the non-discrimination provisions in the tax treaties. Some foreign countries assert that sections 6038A and 6038C impose reporting requirements on foreign corporations with which U.S. companies are not required to comply under the general recordkeeping provisions, thus violating nondiscrimination treaty provisions. In addition, the added cost of complying with the U.S. recordkeeping requirements could deter foreign corporations from investing in or dealing with U.S. companies.

It is questionable whether the United States has the authority to unilaterally enact legislation that overrides existing treaties if the legislation will result in a violation of treaty provisions. However, the effect treaty overrides have on foreign relations and the extent to which parties will cooperate with future treaties has been the subject of wide debate. Even if the reporting requirements do not technically violate existing tax treaties, foreign interests have warned that a perception of violation by the United States could lead to decreased cooperation in future treaty negotiations, decreased interest in U.S. investments, and even "foreign retaliation."

163. For a discussion of the effect 6038A has on tax treaties, see Nicola Palmieri, Section 6038A Violates the Constitution and International Law, 54 Tax Notes 1017 (Feb. 24, 1992).
165. See British Industry, supra note 164; Japan, supra note 164; Switzerland, supra note 164; see also Gordon et al., supra note 92, at 1145-47.
166. See Hearings, supra note 17, at 447 (statement of Mr. Carter) (discussing the risk of retaliation against U.S. companies).
167. See John Turro, Override Articles May Appear in Future U.S. Treaties, Morrison Warns; Foreign Officials Discuss ADR, 49 Tax Notes 593, 609-612 (1990). The validity of treaty overrides is beyond the scope of this note.
relations and foreign investment in the United States necessitate a justification by the I.R.S. for imposing these burdensome reporting requirements.

IV. ALTERNATIVE APPROACHES FOR ENSURING COMPLIANCE WITH TRANSFER PRICING REGULATIONS BY FOREIGN CORPORATIONS

It is reasonable to assume that some foreign corporations engage in some form of U.S. tax avoidance through the use of transfer pricing. However, the reporting requirements are imposed on all FCDCs regardless of whether there is any indication they have engaged in tax avoidance. The goal of the reporting requirements is to provide information that will enable the I.R.S. to use section 482 to reallocate income between those related parties who are engaging in U.S. tax avoidance. To achieve this goal, transfer pricing data must be made available to the I.R.S. Thus, the reporting requirements should be imposed only on those corporations from which the data is needed. A scheme more narrowly tailored would avoid unfairness to innocent parties and would justify the I.R.S.'s assumption of personal jurisdiction over the foreign corporation.

One method to help alleviate the administrative burden on both the I.R.S. and FCDCs is to develop a set of threshold criteria which would trigger application of the reporting requirements of sections 6038A and 6038C. Such a system could identify the corporations and industries prone to commit transfer pricing violations and impose the reporting requirements only on this limited set of corporations, instead of on all FCDC's.

The I.R.S. has already targeted certain industries for audit and used statistics from these industries when compiling data to support enactment of section 6038C and the expansion of section 6038A. The I.R.S. could use this objective criteria to determine

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Tried Diplomacy, 49 TAX NOTES 609, 609-12 (1990); see also Foreign Tax Equity Act is Potential Danger to U.S. Foreign Relations, 90 TAX NOTES TODAY 196-36 (Aug. 30, 1990); International Bankers Cite Discrimination in Recordkeeping Requirements Under Pending Foreign Tax Equity Act, 90 TAX NOTES INT'L 43-20 (Sept. 24, 1990); Japan, supra note 164; Switzerland, supra note 164.

170. See supra part II.B.

171. See Hearings, supra note 17, at 447 (statement of Mr. Carter) (encouraging compilation of "appropriate aggregate data" before attempts are made to curb abuses of § 482, while discouraging reliance on the Subcommittee report based on a study of 36 non-representative taxpayers).
which companies and industries should be targeted. In addition, the discrepancy between the Subcommittee survey and the KPMG Peat Marwick survey suggests that the I.R.S. either has or could develop a system that targets trouble areas fairly well.  

The system for identifying suspect FCDCs should have certain characteristics. First, to save administrative time and money, the system should use information already submitted by the FCDC to the I.R.S. This would eliminate the need to develop additional procedures within the I.R.S. to retrieve new information, and it would eliminate the need to establish and enforce new regulations.

Second, the system for identifying suspect FCDCs should allow the I.R.S. to easily apply the data received to the threshold criteria. The I.R.S. will encounter some increased expense and administrative burdens, as with any new procedure, but currently compiled data should be used to keep these to a minimum. The I.R.S. has the information necessary to compile both balance sheets and income statements for FCDCs. This same information could be used to compute the threshold ratios proposed below.

Third, the system should be difficult to circumvent. The I.R.S. should use multiple factors to indicate when an FCDC falls within the “target group,” triggering the threshold criteria. If a single indicator were used, an FCDC could easily and inexpensively adjust its income statements and balance sheets to avoid meeting the threshold criteria. Also, the indicators selected should give the most accurate indication of transfer pricing violations while decreasing the ability of the FCDCs to avoid detection.

The following ratios, if used together, could provide the objective threshold criteria necessary to indicate a “target corporation.”

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
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<tbody>
<tr>
<td>Net Profit Margin</td>
<td>Net Profit After Taxes/Sales</td>
</tr>
<tr>
<td>Gross Profit Margin</td>
<td>Sales-Cost of Goods Sold/Sales</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>Net Profit/ Assets</td>
</tr>
</tbody>
</table>

The net profit margin shows the corporation’s efficiency, taking

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172. See id. (suggesting that the I.R.S. should focus on effective tax rates instead of the rates of return on assets).

173. See INTERNAL REVENUE SERVICE, supra note 37, at 179, 311 (providing data on foreign-controlled corporations and foreign corporations with U.S. source income).

into account all expenses and taxes paid. The gross profit margin reveals the corporation's profit relative to sales and indicates the efficiency of its operations. Gross profit margin is a helpful indication of a corporation’s pricing policy because the amount remaining after the cost of goods sold is subtracted from total sales and should cover the remaining expenses of the company. If not, the corporation is either overpaying for its goods or undercharging for its products. By combining these ratios, the data reveal the source of increases or decreases in profits, including changes in prices, cost of goods sold or operating efficiency. The return on assets ratio measures the corporation’s use of assets and its profitability on sales.

These ratios should be compared to industry averages to identify any significant deviations, alerting the I.R.S. to a corporation possibly engaged in tax avoidance. The FCDC’s ratios should also be compared with industry averages in the United States in order to determine how well the FCDCs perform relative to wholly-owned domestic corporations.

The two profitability ratios can alert the I.R.S. to incidents of income diversion through unusually high expenses, such as high transfer prices for goods and services or high interest expense. Specifically, a deviation in the gross profit margin can identify unusually high costs of goods sold which could indicate that a foreign related party is overcharging a branch or subsidiary for raw or component materials. If the gross profit margin is within industry standards, a deviation in the net profit margin can identify a corporation with high expenses in its service, intangible and interest expense categories. The I.R.S. could then conduct a further inquiry to determine whether transfer pricing violations were being committed via these avenues. The return on assets ratio can identify a corporation that is underutilizing its assets, again alerting the I.R.S. to a potential transfer pricing violation.

The key to this scheme’s viability is determining the appropriate deviation between industry standards and actual corporate performance before imposing the reporting requirements. Information

175. Id. at 682.
176. Id. at 683.
177. Id.
178. Id.
179. Id.
180. Id. at 684.
regarding industry standards for these ratios can be derived from the I.R.S.'s own statistics of income data. While corporations have many legitimate reasons for deviating from industry standards, the threshold can be structured so that only significant deviations over a short period of time or lesser deviations over a longer period will meet the threshold test. While the latter solution may result in statute of limitation problems, the administrative cost savings may offset portions of the forgone tax revenue and allow the I.R.S. to build a stronger case against FCDC's for the tax years not barred by the statute of limitations.

The I.R.S. should develop exceptions for newly-acquired or start-up companies to account for high costs particular to these situations. In addition, the industry comparison figures should be broken down by both the type of industry and sales volume to account for significant deviations due to economies of scale. Although the I.R.S. currently divides industries into eight major categories and nine subcategories, it may need to develop more specific categories for certain industries.

This proposal will help the I.R.S. enforce U.S. tax laws in several ways. First, it will decrease the number of FCDCs subject to comply with the reporting requirements without sufficient justification, thus curing the overinclusiveness of the current legislation. Second, this system will enable the I.R.S. to identify section 482 violators more easily, thereby using its resources more efficiently. In addition, this system will deter foreign corporations with trades or businesses in the United States from committing transfer pricing violations. Foreign corporations will want to stay within the bounds of the threshold indicators to avoid burdensome and expensive reporting requirements that would otherwise be imposed. If the criteria are developed correctly, corporations would find it difficult, if not impossible, to divert income without triggering the threshold. Finally, this solution meets due process notions of fair play and substantial justice by requiring the I.R.S. to meet a more stringent standard for showing U.S. interest and by showing that the targeted corporations have demonstrated a propensity to violate U.S. tax laws.

Enacting these threshold tests would change the basis on which the reporting requirements are imposed. Changes to current regula-

181. See INTERNAL REVENUE SERVICE, supra note 37.
182. See id. at 315-17; see also supra note 38.
tions would be too substantial for the I.R.S. to effectively adopt the threshold tests through new regulation. Therefore, Congress should enact legislation which reflects the changes suggested in this proposal.

However, even if Congress chooses not to enact new legislation, the I.R.S. can use methods currently available more efficiently to alleviate the shortcomings of sections 6038A and 6038C. The I.R.S. has failed, for one reason or another, to fully use existing tax treaties, administrative summons and formal document requests. These three methods may be more time-consuming to employ than the new regulations, but time should not be the deciding factor when enforcing tax regulations. The inefficiencies of these methods from the I.R.S.'s standpoint do not outweigh the heavy burden that the new regulations impose upon reporting corporations. In addition, there is no assurance that the I.R.S. will use the new regulations effectively or be able to achieve the anticipated results of curbing transfer pricing violations. The I.R.S. should make an effort to determine the utility of the current methods of obtaining foreign based documentation before adopting new ones.

V. SUMMARY

Penalizing transfer pricing violations has the potential to generate substantial revenues. Few will deny the I.R.S.'s authority to enforce the laws and regulations which have been passed. The concern, though, is not with the ends, but with the means in which the I.R.S. seeks to reach those ends. Sections 6038A and 6038C impose broad and sweeping reporting requirements on FCDCs with severe penalties for noncompliance. This approach could have extensive detrimental effects on foreign relations and foreign investment in the United States.

The I.R.S. has options available that achieve its goal of ending transfer pricing violations, but which do not impose intrusive burdens on FCDCs. The easiest option is to use the existing methods of tax treaties, administrative summons and formal document requests to obtain the documentation necessary to investigate suspected FCDC's. However, because the I.R.S. has adopted sections 6038A and 6038C, the best option is to apply threshold criteria, such as those set forth above, before imposing the reporting re-

183. See supra text accompanying notes 92-95 (discussing the I.R.S.'s inability to obtain pricing information).
quirements. The latter option provides both administrative convenience and policy justifications for the reporting burdens, while providing FCDC's with a strong deterrent not to commit transfer pricing violations.

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