TRANSFER PRICING AND VALUATION IN CORPORATE TAXATION: Federal Legislation vs. Administrative Practice

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by

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For Gary

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Preface

Transfer Pricing and Valuation in Corporate Taxation analyzes the disparities between both federal statutes and regulations, and regulations and administrative practice, in a highly controversial area of corporate tax policy: intra-company transfer pricing for tax purposes. It addresses issues that often mean millions of dollars to individual corporations, and a significant fraction of the federal government's revenue base.

These disparities between law, regulations, and administrative practice are concerning on a number of grounds. First, they impose considerable economic costs by inducing corporations to engage in a variety of "rent-seeking" activities designed to reduce their expected tax liabilities, and by requiring the IRS to devote still more to enforcement efforts that are very often futile. Second, they are inherently undemocratic. Administrative practice is currently *ad hoc*; by relying on dispute resolution procedures that can and do yield very different settlements on disputed tax issues from one case to another, the IRS often ends up treating similarly situated corporations very differently. Moreover, to the extent that the disparity between statute and implementation reflects the IRS's failure to carry out Congress' will, the laws passed by duly elected officials are effectively being superseded by administrative procedure, developed incrementally by individuals who are not answerable to an electorate.

Through a series of theoretical case studies that merge limited information from actual cases, I develop specific policy proposals designed to reduce this lacunae between tax law and administrative practice. While the analysis presupposes that existing legislation will remain in place, and, consequently, that regulations and practice should conform thereto, tax laws could as well be changed to conform to regulations or practice. In this spirit, I do not advocate higher or lower effective (or statutory) corporate tax rates *per se*. Nor do I address the normative questions of whether corporations should pay a profits tax at all, or whether a unitary system is preferable to the current separate entity approach to taxing multinational corporations. Rather, I assume that governments will continue to levy corporate profits taxes based on the separate accounting framework.

Tax practitioners who are understandably frustrated in their efforts to divine the IRS's reasoning in transfer pricing issues should find this book very helpful. In addition, it will be an important source of information for elected representatives, IRS and other public officials, and tax lobbyists in the process of evaluating existing corporate tax policy or formulating (or advocating) alternative tax policies, and a useful reference for academics studying international taxation, public finance, and treaty compliance.

I have worked in the field of international corporate taxation since 1986, first as an industryeconomist with the U.S. Internal Revenue Service, subsequently as a consulting economist with a large public accounting firm, and currently as an academic and independent consultant. I drafted the first version of this book in 1990. (The manuscript has since been completely rewritten to incorporate the 1993 temporary and proposed Section 482 regulations, and changes in penalty provisions, Section 936(h), and other relevant legislative initiatives incorporated into the Omnibus Budget Reconciliation Act of 1993.) It has taken over three years to persuade the IRS to clarify the conditions under which I would be permitted to publish this manuscript. In all likelihood, the IRS would never have responded without the concerted effort that Congressman Barney Frank (D-Mass.) made on my behalf, for which I will be eternally grateful.

I was extremely fortunate to have been able to confer with some of the most knowledgeable people in the transfer pricing field in the course of writing this book. Michael Picariello gave very generously of his time and his extensive knowledge of Sections 482 and 936(h). Kevin Fay shared his considerable insights into the workings of IRS management and the IRS Economist Program. Diane Kanakis, an expert in competent authority, was a very helpful resource. Joseph Boorstein served as an invaluable sounding board for my interpretations of the 1993 temporary transfer pricing regulations. I would also like to acknowledge with great warmth and respect my friends and former colleagues at the IRS, from whom I learned a great deal, including especially Ron Calitri, Don Coleman, Joe DeChristofaro, Wendy Jackson, Lee Keenan, Mike Lareau, Bob Majeau, Tom Mason, Denis McSweeney, Manny Melo, George Pallotta, Sam Sahagian, Frank Santos, Paul Blankfeld, Sandy Cohen, Barbara Gallagher, Marco Gonzales, Mar Haeussler, Ralph Harris, Siv Janger, Michael Poyntz, Milagro Richardson, Steve Steinberg, Mike Sweeney, Constance Tripp, Murray Tucker, Dave Wallenstein, Steve Zemsky, Seymour Zwick, and many others. And finally, I thank Gary for his insightful comments, unflagging support, and encouragement.