



Transfer Pricing Thoughts: North America

By Patricia G. Lewis and Matthew W. Frank

Thoughts on Control

A: *Controlled entities*

Q: *What does the IRS call uncontrolled entities in a tax shelter transaction?*

Earlier this year,¹ we explored whether joint ventures between otherwise unrelated parties might be subject to the constraints of Code Sec. 482. While the parties in such ventures do jointly control an enterprise with which they engage in various transactions, the context of two otherwise independent parties, perhaps even competitors, lends an arm's length feeling that may reduce the vulnerability to Code Sec. 482 challenges.

Our column identified three levels of inquiry in a joint venture case:

- (1) Is there in fact "control" within the meaning of Code Sec. 482?
- (2) If so, do the transactions nevertheless meet the arm's length standard because of the nature of the parties' relationship?
- (3) Even if there is no "control" in the first sense, have the transactions "arbitrarily" shifted tax attributes such that "control" will be presumed for Code Sec. 482 purposes?

We noted that the second inquiry – whether there are sufficient countervailing interests among the parties that they are financially motivated to act fairly – takes the pressure off the precise definition of control.² However, we observed that the law is not well developed with respect to the third inquiry, "probably because its inherent circularity blurs the analysis."³

The Internal Revenue Service ("IRS") now seeks to fill the void, by arguing that Code Sec. 482 can be applied to transactions between parties that lack

common ownership but allegedly are acting pursuant to a common design to artificially shift income and deductions. Specifically, in a recent series of Field Service Advices⁴ ("FSAs"), the IRS supports the application of Code Sec. 482 to eliminate sought-after tax benefits in "lease stripping" transactions. Stripped to their core (pun intended), the FSAs rely on the following definition in the Code Sec. 482 regulations:

CONTROLLED includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert with a common goal or purpose. It is the reality of the control that is decisive. . . . A presumption of control arises if income or deductions have been arbitrarily shifted.⁵

The FSAs make good on the IRS' earlier public warning that it would attack lease stripping transactions under Code Sec. 482 (as well as under other authorities where applicable, such as the substance-over-form doctrine, business-purpose doctrine, assignment-of-income principles and Code Sec. 269).⁶ The IRS has made similar threats in other potential tax shelter settings, e.g., with respect to foreign tax credits.⁷

The lease stripping transactions under attack involve complex multi-party transactions designed to create up-front income (e.g., prepaid rent) for a party not subject to U.S. tax, and later deductions

*Patricia G. Lewis and Matthew W. Frank are members of
Caplin & Drysdale, Chtd., in Washington, D.C.*

(e.g., interest, depreciation, Code Sec. 1231 losses) for a U.S. taxpayer seeking to shelter other taxable income, with both parties usually having no relation to the underlying business transaction (e.g., equipment lease). To trigger Code Sec. 482, the FSAs say there must be “a common design for the shifting of income.”⁸ Such a common design can be demonstrated by showing, *inter alia*, that:

- (1) a prearranged structured transaction marketed by a promoter was used;
- (2) the parties’ activities were otherwise unprofitable (aside from tax effects) and un-businesslike, involving uneconomic transactions with circular flows of cash; and
- (3) all the participants received substantial benefits, contingent on their coordinated activity.

Once within Code Sec. 482, the FSAs identify various ways to eviscerate the transaction, including: disregarding contractual arrangements that are inconsistent with economic substance,⁹ allocating income and deductions to clearly reflect income and/or prevent avoidance of taxes,¹⁰ and/or reallocating built-in losses purportedly transferred in a non-recognition transaction such as Code Sec. 351.¹¹

We recognize the IRS’ zeal to assail these transactions for tax policy and revenue reasons — but is Code Sec. 482 the right weapon? In the FSAs, the IRS noted a panoply of other theories that could be used and in most cases concluded that the “sham” argument was the strongest.¹² Recent successes in the *ACM* and *ASA Investments* cases¹³ have surely buoyed the IRS’ enthusiasm for the sham argument, and the Administration seeks to add legislative weapons to the arsenal.

Despite the helpful regulatory language, there are legitimate questions about the legal merits of the IRS’ position on applying Code Sec. 482 to tax shelters, discussion of which goes well beyond the space of this column.¹⁴ Regardless of one’s views on the merits, however, practical and policy perspectives suggest raising Code Sec. 482 only with the utmost care. Code Sec. 482 is vague and broad enough as it is. Application of Code Sec. 482 to

tax shelter cases may prove too much and in any event open a Pandora’s box.

For example, even the most basic sale-leaseback transaction between unrelated parties shifts deductions and income among the parties, often to achieve tax objectives. While it should be easy to distinguish this case because of the parties’ countervailing interests (e.g., one party’s deductible depreciation is the other party’s taxable gain), it is troublesome to contemplate having to run the gamut of Code Sec. 482 to reach that result. In the quest for defined standards that both taxpayers and tax auditors can use to test the acceptability of transactions, Code Sec. 482 does not provide a useful filter. And, although the FSAs indicate that Code Sec. 482’s allocation authority exists “only where there is a common tax avoidance scheme among the participants to arbitrarily shift income and/or deductions,” this just transposes the definitional debate (endlessly) to the meaning of “tax avoidance,” “scheme” and “arbitrary.” Although it seems appropriate that any arbitrariness test contrast countervailing interests with commonality of interests, it is a much broader leap to equate the

latter with tax indifference.

Equally problematic is the circularity of the IRS’ approach — the transaction itself serves as evidence of the control that is the statutory prerequisite to bringing the transaction

within Code Sec. 482 in the first place. Under the IRS stance, the Code Sec. 482 rules would test the parties’ very relationship (e.g., does it have economic substance?) as well as their transactions.

Another slippery slope is the implication for tax treaty provisions relating to commercial and financial relations between “associated enterprises” (typically, Article 9). Were a broad control test to be applied by aggressive treaty partners, things could get out of control (another pun intended).

The IRS’ attempt to appropriate Code Sec. 482 for its assault on tax shelter transactions pushes the envelope on the merits and would overwhelm the analysis, and audit, of multi-party transactions. Code Sec. 482 provides a special presumption of correctness for the IRS, a harder standard of proof for the taxpayer, and broad remedial options — presumably

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the reasons why the IRS seeks to invoke it here. Moreover, the emotions and extremes involved in tax shelter cases could make bad law that is inappropriate for the traditional focus of Code Sec. 482.

Ultimately, the courts will determine whether the IRS' approach is either necessary or supportable.¹⁵ Some transfer pricing practitioners, however, may say "stay out of my space."

ENDNOTES

- ¹ Patricia G. Lewis and Matthew W. Frank. *Transfer Pricing Thoughts*, J. OF GLOBAL TRANSFER PRICING, Feb.-March 1999, at 9.
- ² See, *R.T. French Co.*, 60 TC 836, Dec. 32,119; *R.M. Brittingham*, 66 TC 373, Dec. 33,856. *Aff'd per curiam*, CA-5, 79-2 USTC ¶ 9499, 598 F2d 1375.
- ³ *R.M. Brittingham*, note 2, *supra*. See also companion case, *Dallas Ceramic Co.*, CA-5, 79-2 USTC ¶ 9500, 598 F2d 1382 (1979), *rev'g* and *rem'g* DC Tex., 74-2 USTC ¶ 9830 (1974).
- ⁴ FSAs 199909005 (11/17/98), 199914019 (1/5/99), 199920012 (2/10/99), and 199930004 (3/30/99). See also, FSA 199914001 (10/27/98).
- ⁵ Reg. §1.482-1(i)(4); emphasis supplied
- ⁶ IRS Notice 95-53, 1995-2 CB 334.
- ⁷ IRS Notice 98-5, 1998-3 IRB 49.
- ⁸ See *supra* n. 3.
- ⁹ Reg. §1.482-1(d)(3)(ii)(B)
- ¹⁰ Reg. §1.482-1(a)(1)
- ¹¹ Reg. §1.482-1(f)(1)(iii)

- ¹² FSAs 199914001, 199920012, 199930004, *supra*.
- ¹³ *ACM Partnership*, 73 TCM 2189, Dec. 51,922(M), TC Memo. 1997-115. *Aff'd*, *rev'd* and *rem'd* CA-3, 98-2 USTC ¶ 50,790 157 F3d 231 (1998). *Cert. denied* (1999). *ASA Investorings Partnership*, 76 TCM 325, Dec. 52,845(M), TC Memo. 1998-305.
- ¹⁴ See, John P. Warner, *Control, Causality and Section 482*, 28 TAX MANAGEMENT INTERNATIONAL J., at 403-414 (July 1999), positing that Code Sec. 482 applies only if there is managerial or governance influence or power that causes the income distortion.
- ¹⁵ FSA 199914001 refers to a lease-stripping case pending in the U.S. Tax Court, *Andantech* (No. 15532-98), although the statutory notice does not specifically reference Code Sec. 482; presumably others, spawned by the FSAs and their brethren, will join the pipeline. Note: FSAs merely express an IRS viewpoint and opening shot (probably calculated to intimidate potential tax shelter participants, now that FSAs are published), and are neither binding nor precedential.

An Economist's Perspective

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it may be appropriate to apply CPM to cover both the "investment" period and "recoupment" period. Consider, too, the circumstances under which the CPM may be regarded as providing a reliable and reasonable method for determining the arm's length nature of intercompany prices. The principal circumstance ruling out the CPM is the tested party's ownership of valuable intangible assets.

Where the tested party appears to be entitled to a special markup because of certain unique expertise, the CPM framework does not explicitly permit us to provide for a special return, because in theory, the tested party is without intangibles. Nonetheless, if such a benchmarking exercise were conducted, economists might argue that if the CPM permitted a "quality" adjustment, the ultimate return received by the entity on, say, a marketing intangible should be on a par with the returns obtained by an economic "owner," not a mere service provider.

How then, does one apportion any large economic gains related parties may realize from intangibles? Economists might view the absence of legal ownership to the intangibles developed by a related party as being irrelevant to the answer. The only reason

the legal ownership was not secured in *DHL* was because the parties were related. To an economist, it might seem overly formalistic to ignore the relative investments and economic risks borne by the parties and render a decision based solely on legal ownership. After all, if the parties had been unrelated, the developer presumably would have secured sufficient ownership rights to protect its investment. Consequently, in a situation like *DHL*, some division of profit between the legal owner and the developer makes sense in economic terms. However, the court in *DHL* developed a division of profit based solely on a legal theory of "imperfect" ownership rights. Even if this result in *DHL* were consistent with the result that an economist might reach, it might not be prudent to conclude that the difference in approach is simply one of semantics. Rather, it bears watching future cases to see how this potential conflict might be resolved.

ENDNOTES

- ¹ *DHL Corp.*, 76 TCM 1122, Dec. 53,015(M), TC Memo. 1998-461
- ² Marc M. Levey *et. al.*, *A Tax Court Road Map for Handling Transfer Pricing Audits*, 10 J. INTL. TAX'N 2 (1999). Samuel M. Maruca, *Reap What Ye Sow: The Tax Court's Opinion in DHL Corp. v. Commissioner*. 28 TAX MANAGEMENT INTERNATIONAL J. 207 (April 9, 1999).
- ³ Reg. §1.482-1(d)(3)(ii)(C)
- ⁴ Reg. §1.482-4(f)(3)(iv)