



United States
General Accounting Office
Washington, D.C. 20548

General Government Division
B-258362

September 15, 1994

The Honorable Byron L. Dorgan
United States Senate

Dear Senator Dorgan:

This letter responds to your request for updated information on the Internal Revenue Service's (IRS) administration of section 482 of the Internal Revenue Code, which deals with transfer pricing issues. The enclosed statistical information summarizes IRS' recent experience with section 482 in examinations, appeals, and litigation, following up our 1993 testimony International Taxation: Updated Information on Transfer Pricing (GAO/T-GGD-93-16, Mar. 25, 1993). The information was developed from IRS international examination and appeals data covering the late 1980s through 1993, and from 1993 and 1994 U.S. Tax Court rulings.

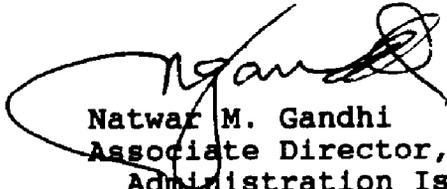
We did not audit any of IRS' management information systems from which we obtained section 482 data. An IRS internal audit report pointed out problems with some international management information systems, which IRS is improving. The management information we used, however, was the best available for full analysis at the time we did our work, which we did in accordance with generally accepted government auditing standards.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this correspondence until 30 days from the date of this letter. At that time, we will send copies to IRS and

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other interested parties. If you have any questions,
please contact me at (202) 512-9044.

Sincerely yours,



Natwar M. Gandhi

Associate Director, Tax Policy and
Administration Issues

Enclosure

INFORMATION ON
TRANSFER PRICING

Table I.1: Proposed Section 482 Income Adjustments of Foreign- and U.S.-Controlled Corporations With \$20 Million or More of Total Proposed Adjustments

Dollars in billions

Fiscal year	Foreign-controlled corporations		U.S.-controlled corporations	
	Number of corporations	Adjustment amount	Number of corporations	Adjustment amount
1989	12	\$0.7	31	\$4.1
1990	11	1.6	26	4.4
1991	12	1.1	23	1.2
1992	13	1.0	37	3.1
1993	18	0.7	33	1.1

Note 1: A few large adjustments significantly affect comparisons of adjustments for foreign- and U.S.-controlled corporations because they comprise large percentages of the totals. Most of the section 482 adjustments for the corporations in 1993 were for tax years before 1990.

Note 2: We generally used IRS' determinations of whether particular corporations were foreign controlled, but if we were aware that an IRS determination was incorrect, we used our own. Foreign-controlled corporations were U.S. corporations of which at least 50 percent (25 percent for returns for tax years after 1990) of the voting stock was owned by a foreign individual, partnership, corporation, estate, or trust. IRS also included in this category foreign corporations operating through branches in the United States. Any corporation not characterized as a foreign-controlled corporation was a U.S.-controlled corporation.

Sources: Data for 1989 through 1992 were accumulated by IRS, and data for 1993 were developed by GAO working with IRS and using information obtained from IRS' International Case Management System.

Table I.2: Sustention Rates for Large Section 482 Issues

Dollars in billions

Fiscal year	Foreign-controlled corporations		Other taxpayers		Total	
	Proposed adjustments	Sustention rate	Proposed adjustments	Sustention rate	Proposed adjustments	Sustention rate
1987	\$0.1	12%	\$0.5	25%	\$0.6	24%
1988	0.5	34%	1.5	25%	2.0	27%
1989	0.2	9%	1.0	43%	1.2	37%
1990	NA	NA	NA	NA	1.8	52%
1991	0.2	24%	2.0	28%	2.2	28%
1992	0.4	5%	1.5	30%	1.9	24%
1993	0.4	20%	0.5	32%	0.9	27%

Note 1: The sustention rate is defined as the ratio of the adjustment amount determined after an issue has been resolved by Appeals, Chief Counsel, or a court to the adjustment amount proposed by examiners. Appeals staff do not track every issue related to section 482 but believe they capture the large ones by focusing on the largest issues in cases that meet certain tax deficiency criteria.

Note 2: IRS highly qualifies sustention rates because the data collected before 1992 were not gathered to measure sustention rates and/or were not subjected to rigorous accuracy checks. Also, IRS cautions that sustention rates for individual issues like section 482 ignore such distortionary effects as those caused by negative proposed adjustments. Finally, according to IRS officials, the fluctuation in sustention rates from year to year might be due to the resolution of a few cases with large dollar implications.

Note 3: The 1991 sustention rate for foreign-controlled corporations (24 percent) differs from the 23 percent that we reported previously, because we had more precise information available the second time than the first. The earlier percentage was included in our 1993 testimony International Taxation: Updated Information on Transfer Pricing (GAO/T-GGD-93-16, Mar. 25, 1993). Also, the 1992 percentages are estimates derived from less precise information than was available for the other years. Finally, almost all of the tax returns covered by the 1993 sustention rates were filed for tax years before 1990.

Source: IRS.

Table I.3: Summary of Major Court Cases With Section 482 Issues Decided Between January 1, 1993, and May 20, 1994

Name	Date of returns at issue	Date of ruling	Amount at issue	Winner and ruling
National Semiconductor Corporation	1978-1982	1994	\$122 million in income ^a	Mixed--The Tax Court increased the taxpayer's income under section 482 by \$40.6 million to bring the pricing relationships closer to what would have occurred at arm's length. According to the Court, neither party presented the Court with evidence that would satisfy any of the prescribed methods of transfer pricing under the section 482 regulations. The Court, however, adopted the IRS expert's analysis with certain modifications as the "least unacceptable methodology" presented.
Seagate Technology, Inc.	1983-1987	1994	\$285 million in income ^b	Mixed--The Tax Court held that IRS' reallocation of income under section 482 was arbitrary and capricious but that the manufacturer failed to prove that the transactions were arm's length. The Court determined the appropriate transfer prices on the basis of its own "best estimate."

Name	Date of returns at issue	Date of ruling	Amount at issue	Winner and ruling
Perkin-Elmer Corporation	1975-1981	1993	\$22 million in income ^c	Mixed--The Tax Court noted that in this case, as in other significant section 482 cases, each party spent most of the time attacking the other party's allocation formula rather than establishing the soundness of its own formula. Thus, the Court was left to find a formula without the benefit of sufficient help from the parties. Income allocations to the taxpayer were less than called for by IRS.
Exxon Corporation/ Texaco, Inc./ Aramco Advantage	1979-1981	1993	Over \$6.5 billion in taxes ^d	Taxpayer--The Tax Court rejected IRS' income reallocation, stating that restrictions from the Saudi Arabian government made a higher transfer price legally unfeasible.

Note: We selected the four cases by reviewing cases decided between January 1, 1993, and May 20, 1994, that involved what we considered to be a major section 482 reallocation issue. IRS officials agreed that we had selected the major cases. Not included in this summary is the Apple Computer case, which was the first transfer pricing case decided by binding arbitration under Tax Court Rule 124. Because the arbitration proceedings were held in private, few details are known. The arbitration panel ruled unanimously in favor of IRS after IRS substantially modified its position, so the arbitration is generally thought of as a victory for IRS.

^aAfter an expert's recommendation was taken into account, the maximum total proposed adjustment at trial was less than \$77 million.

^bAs reflected in expert reports introduced at trial, the total proposed adjustment became \$171 million.

^cIRS' alternative trial position showed income at issue to be \$29 million.

^dAccording to commentators, the Aramco Advantage case represents the biggest dollar deficiency in Tax Court history.

Sources: Court cases.

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