The Honorable Max S. Baucus  
Chairman 
Senate Committee on Finance 
219 Dirksen Senate Office Building 
Washington, DC 20510-6200 

The Honorable Dave Camp 
Chairman 
House Committee on Ways & Means 
1102 Longworth House Office Building 
Washington, DC 20515 

The Honorable Orrin G. Hatch  
Ranking Member 
Senate Committee on Finance 
219 Dirksen Senate Office Building 
Washington, DC 20510-6200 

The Honorable Sander Levin 
Ranking Member 
House Committee on Ways & Means 
1102 Longworth House Office Building 
Washington, DC 20515 

Re: Options for Tax Reform in the Transfer Pricing Provisions of the Internal Revenue Code 

Dear Chairmen and Ranking Members:

Enclosed please find a description of options for tax reform in the transfer pricing provisions of the Internal Revenue Code. These options for tax reform are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These options are submitted as part of a series of tax reform options prepared by the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

The Section would be pleased to discuss the options with you or your staffs if that would be helpful.

Sincerely yours,

Rudolph R. Ramelli 
Chair, Section of Taxation 

Charles H. Egerton 
Former Chair, Section of Taxation 

Enclosure 

cc: Mr. Russell Sullivan, Majority Staff Director, Senate Finance Committee 
Mr. Christopher Campbell, Minority Staff Director, Senate Finance Committee 
Ms. Jennifer Safavian, Majority Staff Director, House Ways and Means Committee 
Ms. Janice A. Mays, Minority Chief Counsel, House Ways and Means Committee 
Mr. Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation 
Honorable Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury 
Honorable William J. Wilkins, Chief Counsel, Internal Revenue Service 
Honorable Douglas H. Shulman, Commissioner, Internal Revenue Service
These options for tax reform (“Options”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

These Options are submitted as part of a series of tax reform options from the American Bar Association Section of Taxation, the objectives of which are to improve the tax laws and to make them simpler to understand and administer.

These Options were prepared by members of the Transfer Pricing Committee (the “Committee”) of the American Bar Association Section of Taxation. Principal responsibility was exercised by Cynthia Kahl, with substantive contributions from Louis Abad, Emebeth Demrew, Michael Mayo, Kathryn Morrison Sneade, and David Young. These Options were reviewed by Sean Foley, Chair of the Committee, Mark Martin, Vice-Chair of the Committee, and Tracy Gomes, Vice-Chair of the Committee. The Options were further reviewed by David Canale of the Section’s Committee on Government Submissions and by Brian P. Trauman, Council Director for the Committee. The Options were also reviewed by Armando Gomez and Reuven S. Avi-Yonah on behalf of the Section of Taxation’s Tax Reform Steering Committee.

Although many of the members of the Section of Taxation who participated in preparing these Options have clients who may be affected by the federal tax principles addressed in these Options or have advised clients on the application of such principles, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Options.

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Date: October 1, 2012
Executive Summary

1. **Arm’s Length Standard.** Section 482 allows the Commissioner to allocate or apportion the incomes of related entities to reflect their true tax liabilities. While the arm’s length standard is not referenced in section 482, it is the main standard underlying the statute and has been in force for over 80 years, since transfer pricing was first recognized in the IRC. The arm’s length standard relies on a flexible system of international cooperation and negotiation, not on rigid formulas that fail to reflect market conditions and the facts and circumstances of cross-border economic transactions. Transfer pricing must reconcile competing incentives between the actors involved, while dealing with the problem of inherently subjective valuation of assets and profits. Referencing the arm’s length standard in the statute would ensure consistency of the authority granted to the Secretary with the cornerstone underlying the inception of the statute, and avoid the risks of over or under taxation inherent in proposed alternatives to the arm’s length principle, such as a worldwide formulary apportionment system. Therefore, we recommend consideration of the following option: Addition of language recognizing the arm’s length principle in section 482.

2. **Section 6662(e) Transactional Penalty.** The transactional penalty of section 6662(e)(1)(B)(i) is rarely, if ever, applied. Nevertheless, corporate taxpayers must still consider the penalty for purposes of financial statement reporting. As a result, the penalty is an unnecessary administrative burden for taxpayers, adding little value to the current tax regime. We therefore recommend consideration of the following option: Elimination of the transactional penalty of section 6662(e)(1)(B)(i).

3. **Global Documentation Standard.** U.S. transfer pricing documentation standards are currently not harmonized with global guidelines; in particular, the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the “OECD Guidelines”) and the European Union transfer pricing documentation standards. However, establishing a common global transfer pricing documentation standard, which does not yet exist, would entail the following benefits:
   1. Simplify transfer pricing requirements for cross-border transactions;
   2. Reduce worldwide transfer pricing documentation compliance costs for multinational enterprises (MNEs);
   3. Enhance transparency of transfer pricing transactions;
   4. Increase consistency (not only for documentation, but also in the application and enforcement of transfer pricing);
   5. Reduce exposure to penalties pertaining to documentation deficiencies; and
   6. Facilitate implementation of transfer pricing.

   Therefore, we recommend consideration of the following option: Provide direction to Treasury to negotiate a new set of global documentation standards as
a collaborative process with treaty partners and organizations for the purpose of harmonizing the current U.S. transfer pricing documentation standards with global guidelines.

4. **Customs Valuation.** Currently, section 1059A can prevent taxpayers from recording arm’s length amounts on their income tax returns where a consistent reporting position has been taken for customs purposes, but such position is taken after the customs value has been “finally-determined” for customs purposes. Therefore, we recommend consideration of the following option: Change the language of section 1059A(b)(1) to eliminate circumstances where section 1059A can prevent taxpayers from recording arm’s length amounts on their income tax returns, when that amount is consistent with the amount reported for customs purposes.
I. Arm’s Length Standard

a. Present Law

In 1928, Congress passed the Revenue Act of 1928, allowing the Commissioner to allocate or apportion the incomes of related entities to reflect their true tax liabilities. Section 45 of this Act contained the first sentence of section 482.

In 1986, the second sentence of section 482 was added as part of the Tax Reform Act of 1986, introducing the commensurate with income standard. Section 482 has remained largely unchanged since the introduction of its two sentences in 1928 and 1986, experiencing only minor cosmetic revisions.

The arm’s length standard is not expressly stated in the language of section 482. The statute, instead, grants the Secretary the authority to make certain adjustments to “clearly reflect income.”

b. Reasons for Change

While the arm’s length standard was not referenced in section 482, it was the cornerstone underlying the inception of the statute in section 45. The current Treasury Regulations also unequivocally sanction the use of the arm’s length standard. Treas. Reg. § 1.482-1(a)(1) describes the purpose and scope of section 482. The dual purpose is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. The regulation states that “Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.” The method to determine the true taxable income of a controlled taxpayer is the arm’s length standard (the “standard to be applied in every case”), as described in Treas. Reg. § 1.482-1(b)(1).

References to a “section” are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

A Study of Intercompany Pricing Under Section 482 of the Code, Notice 88-123, 1988-2 C.B. 458, 459. (hereinafter 1988 Treasury White Paper) (“The regulations [Reg. 86, § 45.1(b) (1935)] set forth the arm's length standard as the fundamental principle underlying section 482: ‘The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.’”).

The scope and purpose language of Reg. § 1.482-1(a)(1) has appeared in every succeeding version of the regulations: See Reg. 94, § 45-1(b) (1936); Reg. 101, § 45-1(b) (1939); Reg. 103, § 19.45-1(b) (1940); Reg. 111 § 29.45-1(b) (1943); Reg. 118, § 39.45-1(b) (1953); Reg. § 1.482-1(b), (c) (1965); Reg. § 1.482-1(b), (c) (1986). See also Lake Erie & Pittsburg [sic] Ry. Co. v. Commissioner, 5 T.C. 558, 563-65 (1945) (discussing the versions appearing in the Revenue Acts of 1936 and 1938); Essex Broadcasters, Inc. v. Commissioner, 2 T.C. 523, 528-30 (1943) (discussing the version appearing in the Revenue Act of 1938). See generally James William Lewis, Section 482: An Eminently Amendable Provision, 25 ALA. L. REV. 23, 25-26 (1972-73). For a detailed discussion on the history of Section 482, see Francis M. Allegra, Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review, 13 VA. TAX REV. 423, 435-53 (1994).
U.S. government officials continue to stress that the United States will support the arm’s length principle for transfer pricing purposes.4

The OECD Guidelines have endorsed the arm’s length standard as the international standard to be used by OECD member countries for tax purposes involving multinational groups since the League of Nations’ 1933 Draft Convention on the Allocation of Business Profits between the States. The arm’s length standard is the “international transfer pricing standard that OECD member countries have agreed should be used for tax purposes by [multinational enterprise] groups and tax administrations.”5 The most current version of the OECD Guidelines, approved in July 2010, continue to reaffirm the arm’s length standard as the international standard.6

The Council of the European Union (EU Council) issued a code of conduct for transfer pricing documentation for associated enterprises in the European Union (EU TPD) on June 27, 2006. The EU TPD is a resolution by the member states of the EU Council that is designed to enable uniform transfer pricing documentation within the European Union. The EU TPD is non-binding, so EU member states are not obliged to model their own country’s transfer pricing documentation after the EU TPD. However, to date, most of the EU member states that have issued transfer pricing documentation regulations since the EU TPD was issued in 2006 have adopted the EU TPD.7 The EU TPD, like the OECD Guidelines and the U.S Treasury Regulations, endorses the arm’s length standard.

The arm's length standard has been incorporated into most modern model income tax treaties.8 The United States bilateral income tax treaties have also uniformly adopted the arm’s length standard.9 There are over 67 U.S. income tax treaties in force.10 Every U.S. income tax treaty includes a reference to the arm's length standard.11

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4 Transfer Pricing’s Arm’s Length Principle, Tax Administrations at Stake, Danilack says. DAILY TAX REP. (BNA), G-6 (2011).
5 OECD Guidelines, Paragraph 1.1 (all citations to the OECD Guidelines refer to the version published on August 18, 2010).
6 Id.
7 Including member states such as Belgium, France, Ireland, Italy, Netherlands, Romania, Slovak Republic, Spain, and Sweden.
9 1988 Treasury White Paper, Notice 88-123, 1988-2 C.B. 458, 475 (“The arm's length standard is embodied in all U.S. tax treaties; it is in each major model treaty, including the U.S. Model Convention; it Footnotes continued on the next page.
Due to the subjective nature of the arm’s length standard and the practical difficulties in its application, practitioners and scholars have suggested transitioning away from the arm’s length standard into a worldwide formulary apportionment system.\textsuperscript{12} However, there are numerous concerns over the feasibility of instituting such a system. The first and foremost concern is that a worldwide formulary apportionment system will cause double taxation (or double non-taxation) in cross-border transactions when the formulas used by the countries involved are not fully in sync with one another. This concern was voiced at a recent Ways and Means Committee hearing by Stephen E. Shay, who served as Deputy Assistant Secretary (International Tax Affairs) at the Treasury Department at the time of the hearing. Mr. Shay stated that a formulary approach has the potential to lead to double taxation if the tax systems of foreign countries and the U.S. are not parallel, and affirmed the Treasury’s position supporting the arm’s length standard.\textsuperscript{13} Chairman of the Committee of Ways and Means, Rep. Dave Camp, expressed a similar concern over the ability to realize a worldwide formulary apportionment system without facing problems such as double taxation and hurting international competition.\textsuperscript{14} The OECD Guidelines also note the difficulty of implementing a worldwide formulary

\textsuperscript{13} “I’m not prepared to say how we would approach a proposal for formulary apportionment at this time. I can say that we have, and are strong supporters of the arm’s-length standard. Adopting formulary apportionment without very broad or a significant international consensus, poses important problems and difficulties, and significantly, the risk of both non-taxation and excess taxation if there is not a parallel system in different countries.” Transfer Pricing Issues in the Global Economy: Hearing Before the House Committee on Ways and Means, FEDERAL NEWS SERVICE, 111th Congress (July 22, 2010) (statement of Stephen E. Shay, Deputy Assistant Secretary, U.S. Department of Treasury).
\textsuperscript{14} “[S]hifting to an arbitrary, so-called formula apportionment system ignores not only the international competition U.S. company employers already face, but also ignores the fact that such a move would expose worldwide American companies to double taxation. And unless foreign countries adopt a similar formula, and virtually all use our current arm’s-length standard to determine fair market value, the result could be double taxation, . . . And if the apportionment is based on something like the percentage of payroll paid in the U.S. versus what’s paid abroad, such a system might create a perverse incentive to ship jobs overseas, to lower a company’s overall tax burden.” Transfer Pricing Issues in the Global Economy: Hearing Before the House Committee on Ways and Means, FEDERAL NEWS SERVICE, 111th Congress (July 22, 2010) (statement of Rep. Dave Camp (M.I.), Chairman, House Committee on Ways and Means).
The OECD Guidelines explain that implementing a global formulary apportionment system effectively (thereby avoiding double taxation/double non-taxation) would require substantial international coordination and consensus. Failure to implement the system in all countries would result in possible double (or under) taxation and the operation of two concurrent systems (arm’s length and formulary apportionment). Member countries would need consensus on: the actual adoption of the approach in the first place, the measurement of the global tax base, the use of a common accounting system, and the factors used to apportion the tax base among countries (including non-member countries).

Chapter 1, Part C of the OECD Guidelines provides an informative outline of the secondary, but perhaps equally as important, considerations against replacing the arm’s length standard with a worldwide formulary apportionment system. Two considerations listed in the OECD Guidelines are of utmost importance. First, there is potential for manipulation of profits with a global formulary apportionment system due to factors within the pre-determined formula that are subject to manipulation by both governmental administrations (incentivized to maximize their own country’s revenue through the manipulation of formulae weights) and taxpayers (incentivized to minimize their taxes by artificially shifting profits to low-tax jurisdictions through the manipulation of production factors in pre-determined formulae, achieved by entering into unnecessary financial transactions or by deliberate location of mobile (intangible) assets). The other important issue highlighted by the OECD is the notion that pre-determined formulae are arbitrary and disregard market conditions, such as the particular circumstances of the individual enterprises and management’s own allocation of resources. A pre-determined formula would not take into account differences in functions, assets, risks, and efficiencies among multinational enterprise members. The OECD Guidelines list a host of other considerations against the execution of a global formulary apportionment system, and conclude that “global formulary apportionment . . . would not be acceptable in theory, implementation, or practice.”

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15 OECD Guidelines, Paragraph 1.22: “The most significant concern with global formulary apportionment is the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation.”


17 In recent years, there has been worldwide momentum to converge accounting reporting into a single set of international financial standards. Currently, more than 120 countries and reporting jurisdictions permit or require International Financial Reporting Standards for domestic listed companies. International Financial Reporting Standards (IFRS): An AICPA Backgrounder, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (“AICPA”), at 2-3 (2011).

18 OECD Guidelines, Paragraph 1.22.

19 OECD Guidelines, Paragraph 1.25.

20 OECD Guidelines, Paragraphs 1.26-1.31.

21 OECD Guidelines, Paragraph 1.15.
Transfer pricing involves reconciling competing incentives: between tax administrations that are pitted against one another in the fight for their share of the MNE’s profits, the governments’ incentive to manage tax rates and deductions in order to keep and create jobs within its own jurisdictions, and the taxpayer’s incentive to minimize its own overall global tax rate, including the avoidance of double taxation. Transfer pricing is a multidisciplinary practice area encompassing the fields of economics, law, and accounting. It uses these subject matters to reconcile subjective valuations made by people from different cultures and perspectives. Transfer pricing must reconcile competing incentives between the actors involved, while dealing with the problem of inherently subjective valuations of assets and profits. The best way to manage these issues is through international cooperation and negotiation that operates within a system that lends itself to flexibility, not on rigid formulas that fail to reflect market conditions and the facts and circumstances surrounding the economic realities of cross-border monetary transactions.

c. Option for Consideration

We recommend consideration of the following option: Addition of language recognizing the arm’s length principle in section 482, memorializing the standard that has been in force for over 80 years, since transfer pricing was first recognized in the Code. The proposed amendment would include the phrase “achieve an arm’s length result between” before “to prevent evasion of taxes or clearly to reflect the income.” The first sentence of section 482 would read:

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) 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 achieve an arm’s length result and to prevent evasion of taxes or to clearly reflect the income of any of such organizations, trades, or businesses.
II. Section 6662(e) Transactional Penalty

a. Present Law

Pursuant to section 6662(e), a penalty is imposed on any underpayment attributable to a substantial valuation misstatement pertaining to either:

(1) A transaction between persons described in section 482 (the transactional penalty); or
(2) A net section 482 transfer price adjustment (the net adjustment penalty).

The penalty is equal to 20 percent of the underpayment of tax attributable to that substantial valuation misstatement. Pursuant to section 6662(h), the penalty is increased to 40 percent of the underpayment in the case of a gross valuation misstatement with respect to either penalty.22

b. Reasons for Change

These penalty provisions underwent significant modifications in a relatively short period of time after their inception in the Omnibus Budget Reconciliation Act (OBRA) of 1989. However, since 1993, Congress has left the substantial and gross valuation penalties in connection with transfer pricing misstatements largely untouched.23 Congress may wish to revisit certain aspects of these penalty provisions in order to conform the penalties with current tax law and accounting guidance, such as Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (recently codified as FASB ASC 740-10 (FIN 48)), and to re-evaluate if the policy objective of providing a disincentive for non-compliance of the contemporaneous preparation of transfer pricing documentation is still being met by these penalty provisions.24

Specifically, we believe the transactional penalty of section 6662(e)(1)(B)(i)25 is unnecessary and adds little value to the current tax regime for the following reasons:

(1) The disparity between the amount stated on the relevant federal tax returns26 and the arm’s length amounts rarely satisfies the 50% or 200% thresholds under section 6662(e).

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22 Reg. § 1.6662-6(a)(1).
23 These penalty provisions were modified in OBRA ’90 and OBRA ’93. For a detailed chronology of the various transfer pricing misstatement penalties please refer to: William G. Dodge, et al., “Transfer pricing: Records and Information,” 891 TAX MNGT. PORT. (BNA) A-161 (2009).
24 The 1993 preamble to the penalty proposals states that the IRS was concerned with the taxpayer’s inability to provide an explanation of internal intercompany pricing policies and the taxpayer’s failure to rely upon company comparables studies in establishing their intercompany pricing.
25 I.R.C. § 6662(e)(1)(B)(i) only applies to transfer pricing related substantial valuation misstatements.
26 IRS Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations and IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation.
(2) Nevertheless, in those rare instances where a transaction falls outside of the 50% or 200% thresholds (such as when no payment has been made between the related parties for a transaction subject to section 482) the reasonable cause and good faith exception of Treas. Reg. § 1.6664-4 will come into effect in most instances. The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Treas. Reg. § 1.6662-6(f) allows only one accuracy-related penalty to be imposed when a valuation misstatement is made (absent fraudulent intent). Thus, the transactional penalty would only be necessary for circumstances below the threshold for the net adjustment penalty, i.e., $5,000,000. Furthermore, Treas. Reg. § 1.6662-6(f)(2) states that the net adjustment penalty will apply at a 40% rate (and the transactional penalty would not apply) for net section 482 adjustments over $20,000,000. Thus, for any material misstatements (defined for our purposes as adjustments over $5,000,000), the transactional penalty is unnecessary.

(3) It is the understanding of ABA Transfer Pricing Committee that the IRS has rarely, if ever, applied the transactional penalty. This is probably due to a combination of the reasons set forth above.

(4) Despite the fact that the penalty is rarely applied, corporate taxpayers must still consider the penalty for purposes of FIN 48. FIN 48 is an interpretation of FASB Statement No. 109 regarding the calculation and disclosure of reserves for uncertain tax positions. Taxpayers are required to accrue both interest and penalties that, under relevant tax law, the taxpayer would incur if the uncertain tax positions ultimately were not sustained. Booking a reserve for a theoretical penalty exposure that will never materialize is an unnecessary administrative burden for taxpayers from an analysis perspective and from an actual accrual basis.

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27 The general reasonable cause and good faith exception of Reg. § 1.6664-4 is applicable to the transactional penalty. See Reg. § 1.6662-6(b)(3). In contrast, the general reasonable cause and good faith exception is not applicable to the net adjustment penalty. The sole method of avoiding the net adjustment penalty when a material transfer pricing adjustment has been assessed is to have complied contemporaneously with the transfer pricing documentation requirements under Reg. § 1.6662-6(d). See Reg. § 1.6662-6(c)(6).

28 This understanding is based on discussions with numerous practitioners, the IRS, Treasury, and congressional staffers.

29 It should be noted that because the exposure for the transactional penalty, as compared to the net adjustment penalty, applies only to adjustments under $5,000,000, it may be the case that the transactional penalty exposure is determined to be immaterial for financial accounting purposes.
c. **Option for Consideration**

We recommend consideration of the following option: For purposes of simplifying section 6662(e), striking of section 6662(e)(1)(B)(i), which currently states:

the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons described in section 482 is 200 percent or more (or 50 percent or less) of the amount determined under section 482 to be the correct amount of such price, or

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III. Global Documentation Standard

a. Present Law

In order to avoid the various transfer pricing penalties of section 6662, taxpayers must prepare contemporaneous documentation that follow the requirements (the principal documents) listed under Treas. Reg. § 1.6662-6(d)(2)(iii)(B)(1)-(10). Failure to satisfy the documentation requirement, absent a minor or inadvertent omission made in good faith, can result in the assessment of a penalty in the event that a reallocation exceeds a statutory threshold. The list of principal documents is prescriptive and does not lend itself to much flexibility.

b. Reason for Change

In recent years, more and more countries have issued transfer pricing documentation regulations and guidelines. Most of these regulations tend to endorse the transfer pricing documentation guidelines as set by the OECD or the EU Council. The OECD Guidelines provide general principles, guidance, and useful information for taxpayers to take into account when preparing their documentation, but they do not present a set of documents that can be universally applied to protect taxpayers against penalties or adjustments. In contrast to the OECD approach to documentation, the EU TPD issued in 2006 provides very specific outlines, detailing documents and information to be prepared by MNE’s in the form of a masterfile or country-specific documentation reports. In the early 2000s, members of the inter-governmental tax organization, the Pacific Association of Tax Administrators (PATA), sought to create one set of uniform transfer pricing documentation (PATA Documentation Package) to meet the members’ respective transfer pricing documentation provisions.

Given the numerous attempts to harmonize transfer pricing documentation, as referenced above, it is clear that there is a strong global consensus between major U.S. treaty partner countries to enact a global transfer pricing documentation standard. To achieve this end, we believe Treasury should be directed to enter into consultations with the OECD to develop and implement global standard documentation requirements. This will include amending the requirements as mandated by the principal documents of Treas. Reg. § 1.6662-6(d)(2)(iii)(B)(1)-(10), as necessary, in order to negotiate successfully with foreign governments to establish a global documentation standard.

31 The PATA member countries involved in the PATA Documentation Package effort were Australia, Canada, Japan and the United States.

c. Option for Consideration
We recommend consideration of the following option: Addition of a new section “b)” to section 482:

§ 482. Allocation of income and deductions among taxpayers.
b) In consultation with international organizations, e.g., the Organization for Economic Co-Operation and Development, the Secretary shall develop and implement standard documentation requirements to provide evidence of arm’s length treatment of transactions made between organizations, trades, or businesses that are owned or controlled directly or indirectly by the same interests.
VI. Customs Valuation

a. Present Law

In order to meet the arm’s length standard under transfer pricing rules, companies importing goods into the U.S. from their related entities are sometimes required to make upward transfer pricing adjustments. Although these upward transfer pricing adjustments may satisfy the arm's-length standard for transfer pricing purposes, the adjustments may create potential uncertain tax positions due to the inventory valuation limitation under section 1059A.33

Pursuant to section 1059A, the value of property imported from a related person that is taken into account for computing the basis or inventory cost of such property cannot exceed the amount taken into account in computing the customs value of such property.34 The “customs value” of property is “the value taken into account for purposes of determining the amount of any customs duties or any other duties which may be imposed on the importation of any property.”35 In enacting section 1059A, Congress intended to impose a ceiling on transfer price valuations for income tax purposes36 to prevent taxpayers from “whipsawing” the government by claiming one (lower) value for customs purposes, and another (higher) value for transfer pricing purposes.

Treasury has provided a framework for the implementation of section 1059A through Treas. Reg. § 1.1059A-1. Under the Treasury regulations, customs values are considered “finally-determined” for purposes of section 1059A when liquidation of the customs entry becomes final.37 While some exceptions are provided, in general, customs entries are “liquidated” approximately 314 days after the date of importation.38 The Treasury regulations provide that, generally, liquidation is considered to be “final” after 90 days following notice of liquidation, unless a protest is filed.39

33 Mark A. Ludwig, Managing the Transfer Pricing and Customs Valuation Nexus, 16 TAX MGMT. TRANS. PRICING REP. (BNA) 643, 646 (2007).
34 I.R.C. § 1059A(a).
35 I.R.C. § 1059A(b).
37 Reg. § 1.1059A-1(d).
38 Under customs statute 19 U.S.C. § 1504(a) and corresponding customs regulations, U.S. Customs Service generally has one year from the date of import entry to liquidate an entry, otherwise, subject to some exceptions, the entry liquidates by operation of law.
39 Id. The 90-day reference contained in Reg. § 1.1059A-1(d) is no longer consistent with the “protest” period in which importers can challenge a liquidation under the customs laws. Congress extended the post-liquidation window for a “protest”, or adjustment to liquidation, from 90 days to 180 days in 2004. The Treasury regulations have not been changed to reflect the change in customs law. See Miscellaneous Trade and Technical Corrections Act of 2004, Pub. L. No. 108–429, 118 Stat 2434.
Under current law, this definition of final customs value for tax purposes can result in an additional income tax burden, beyond the amount otherwise due, in situations where customs valuations are accurately disclosed to the U.S. Bureau of Customs and Border Protection (“Customs”) after the customs value has liquidated (e.g., where a retroactive compensating transfer-price adjustment takes place post-liquidation).40

b. Reasons for Change

The arm’s length standard needs to be reconciled for customs and transfer pricing purposes. For many decades, taxpayers have dealt with the frustration of the divergence between the application of the arm’s length principle by two of the major revenue collection arms of the U.S. Government: the IRS, for transfer pricing purposes, and Customs, for customs valuation issues. The objective of the income tax transfer pricing rules and the customs related-party valuation rules is to arrive at an arm’s length price on transactions between related parties.41 However, because the purposes of the respective laws are fundamentally different – the transfer pricing rules aim to allocate income between related parties to clearly reflect the income for each party, thereby preventing the shifting of income between tax jurisdictions, whereas the customs laws seek to determine the dutiable value of specific imported goods on the basis of their classification and value – their interpretation of what constitutes “arm’s length” has been inconsistent.42 Tax administrations are motivated to minimize imported cost of goods sold (COGS), thereby increasing income, while customs administrations are motivated to maximize COGS (and thus import prices), creating higher dutiable values and processing fees.43 Taxpayers have been flummoxed with how to properly narrow the gap between the two standards and arrive at a convergent application of the arm’s length principle for transfer pricing and customs purposes.

In practice, taxpayers run into a number of hurdles due to the conflict with the nexus between customs and transfer pricing rules, such as: 44

1. Inappropriate comparables and approach for profit evaluation purposes;
2. Inconsistent application of the transfer pricing policy to individual transactions;

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42 For a discussion on the differences between transfer pricing and customs valuation issues, see William M. Methenitis and Steven C. Wrappe, The Growing Need for Harmonization of Transfer Pricing and Customs Valuation, 17 TAX MGMT. TRANS. PRICING REP. (BNA) S-3 (2008).
43 Todd R. Smith and Clark J. Chandler, Recent Developments in Integrating Customs, Transfer Pricing, 19 TAX MGMT. TRANS. PRICING REP. (BNA) 600 (2010).
44 For a set of case studies illustrating these issues, see Douglas Zuvich, Andrew Siciliano, Sean F. Foley, and Clark J. Chandler, The Nexus Between Customs Valuation and Transfer Pricing, 18 TAX MGMT. TRANS. PRICING REP. (BNA) 365 (2009).
(3) Post-importation retroactive price adjustments;
(4) Manufacturer losses or inadequate profits in the supply chain; and
(5) Lack of available segmented financial data from the parent company to reflect sales of specific categories of merchandise.

The OECD and practitioners have urged the tax and customs authorities to converge customs and transfer pricing rules and policies, pushing for transfer pricing documentation to be used, in some cases, for customs purposes.

Documentation requirements for transfer pricing and customs purposes need to be reconciled. Customs has stated that a transfer pricing study alone will not prove that a related party transaction is arm’s length for U.S. Customs purposes. The World Customs Organization (WCO) has stated that it will evaluate what methods under the OECD Guidelines can be utilized for customs valuation purposes. In particular, the WCO has considered to what extent a transfer pricing study can be accepted as the basis for a customs value and how post-importation price adjustments should be dealt with. The Technical Committee on Customs Valuation (TCCV) answered these questions, in part, in Commentary 23.1. Commentary 23.1 states that transfer pricing studies may serve as a possible basis for a Customs analysis when examining the circumstances surrounding a particular sale, but notes that transfer pricing studies may not be relevant in examining a sale due to substantial and significant differences existing between valuation methods as directed by the Customs Agreement and the OECD Guidelines. The Commentary left many questions unanswered, such as how post-importation price adjustments should be handled and guidance on how the OECD valuation methods should be evaluated with the Customs method.

49 Examination of the Expression ‘Circumstances Surrounding the Sale’ Under Article 1.2(A) in Relation to the Use of Transfer Pricing Studies.” This commentary was adopted during the TCCV’s 31st session in October 2010, and is subject to modification.
Unfortunately, there is no easy legislative solution to bridging the divergences between the arm’s length standard as applied by Customs and the IRS. Practitioners agree that convergence between transfer pricing and customs laws would require an extensive overhaul of both bodies of authority.\textsuperscript{51} Such comprehensive reform is beyond the scope of these comments. One reform measure that would help integrate customs and transfer pricing would be to eliminate circumstances where section 1059A can prevent taxpayers from recording arm’s length amounts on their income tax returns when a consistent position has been taken for customs purposes on a prior disclosure filed by the taxpayer no later than 180 days after the taxpayer timely files its United States income tax return.

The following example illustrates the issue and the option recommended for consideration:

\textit{Example}

Taxpayer imports property on January 1, 2011, and declares the customs value to Customs at $100 on the import entry. The customs value “liquidates” on November 11, 2011 (i.e., notice of liquidation is received 314 days after entry). Under existing Treasury regulations, the liquidation becomes final 90 days later on February 9, 2012. Thus, the taxpayer’s inventory basis for the imported property may not exceed $100 for tax purposes.

However, the taxpayer determines after February 9, 2012, that the initially declared customs value was incorrect as it should have been $120 (e.g., by reason of retroactive transfer price adjustment or undeclared element of customs value that is also attributable in the tax cost basis). The taxpayer reports the additional $20 to Customs, and pays duties thereon, through a voluntary “prior disclosure,” which as a matter of Customs procedure does not result in an adjustment in liquidated value, but does offer the taxpayer protection for customs penalties for the customs undervaluation violation. As a matter of Customs administrative procedures and policy, there is no administrative procedure available to the taxpayer to upwardly adjust the liquidated customs value to $120.

Under current law, the taxpayer’s cost basis in the importer property would still be limited to $100, despite the fact that the customs value was actually determined to be $120, and despite the fact that undervaluation and full $120 value was reported to Customs through a prior disclosure.

The proposed rule is intended to permit the taxpayer to include the additional $20, declared in the prior disclosure, in the cost basis of the imported property for tax purposes as long as a prior disclosure concerning the undervaluation is filed by the taxpayer no

later than 180 days after the taxpayer timely files its United States income tax return (including extensions). This would effectively extend the period of time for making adjustments to the section 1059A cost basis for tax purposes only, notwithstanding differences between the tax and Customs administrative rules.

The proposed change will prevent taxpayers from paying taxes not otherwise due solely as a result of timing differences between customs determinations (typically within 180 days after liquidation) and income tax accounting rules (typically annual).

The proposed change would not allow or encourage taxpayers to avoid taxes or customs duties, or disturb the intent of Congress. In enacting section 1059A, Congress sought to prevent taxpayers from “whipsawing” the Treasury, not to impose the timing standards used for Customs purposes upon income tax determinations. The proposed amendment will better effectuate the intended purpose of section 1059A. Finally, the proposed amendment is limited to the period in which taxpayers can make the relevant adjustment to their imported values under Treas. Reg. § 1.482-1(a)(3) (i.e., at the time of the filing the original return for the taxable year (including any extension)).

c. **Option for Consideration**

We recommend consideration of the following option: For purposes of better coordinating the transfer pricing rules of section 482 with section 1059A, change section 1059A(b)(1) as follows:

“Customs value.—
For purposes of this section, the term ‘customs value’ means the value taken into account for purposes of determining the amount of any customs duties, any other duties, or penalties, which may be tendered or imposed on the importation of any property and shall include any amounts concerning the customs value of imported property disclosed in a prior disclosure under the customs laws notwithstanding the final liquidated customs value of the imported property, provided that any such prior disclosure is filed by the taxpayer no later than 180 days after the taxpayer timely files its United States income tax return (including extensions).”

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52 Taxpayers who attempt to understake the value of goods for customs purposes would continue to be prohibited from taking an inconsistent position for income tax purposes by IRC § 1059A.

53 See note 36, supra.