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I.R.S. Stepping Up Transfer Pricing Compliance

Transfer Pricing Compliance Directive, January 22, 2003

Overview

On January 22, 2003, the I.R.S. issued a directive and covering memorandum on the "Transfer Pricing Compliance Process" (the "Directive"). The Directive is intended to reenergize I.R.S. efforts to assure taxpayer compliance with the U.S. transfer pricing rules and to advise field agents of transfer pricing initiatives and priorities. The Directive states that transfer pricing is a top priority in the I.R.S.'s "globalization strategic initiative."

Background

The Directive is based on the transfer pricing penalty regime of § 6662, which imposes penalties on taxpayers with large understatements of tax attributable to § 482 adjustments. The penalty is equal to 20 or 40 percent of the tax understatement, depending on the magnitude of the § 482 adjustment. An understatement of tax for a taxable year attributable to a § 482 adjustment is not counted in measuring the penalty if the taxpayer produces documentation (which it had prepared by the time the return for the taxable year was filed) within 30 days of an I.R.S. request and the documentation shows that the taxpayer reasonably attempted to apply the "best" transfer pricing method in determining the transfer price at issue. It appears that the I.R.S. has often failed to request the § 6662 documentation, causing some taxpayers to wonder whether it was necessary to comply with the transfer pricing self compliance rules.

The Directive

The Directive instructs field agents to request the § 6662 documentation at the joint opening conference for each audit cycle. If a taxpayer does not have the documentation, the Directive instructs field agents to issue an IDR requesting information on the taxpayer's transfer pricing practices (unless recent experience suggests that a transfer pricing examination is unnecessary). Documentation furnished under this rule is then reviewed by an international examiner and/or an economist to determine whether transfer pricing must be included in the audit plan. The Directive states that the Penalty Screening Committee must review the matter before imposition of a § 6662 penalty in a 30- or 90-day letter, but the only basis for not imposing a penalty in such a case is that the taxpayer reasonably carried out the self-compliance process mandated by the regulations under § 6662(e).

Planning Considerations

The Directive is a significant enforcement initiative in the transfer pricing area and taxpayers with transfer pricing issues should take heed and review their transfer pricing planning and procedures. Taxpayers who have made a reasonable effort to satisfy the self compliance regime under § 482 should find comfort in the Directive since, as a practical matter, the I.R.S. may be more likely to accept the taxpayer's transfer prices without substantial further examination activity. On the other hand, for taxpayers who have not followed the self-compliance regime, there is now an increased audit risk on transfer pricing and such taxpayers should view the Directive as a warning. As an alternative to annual compliance, taxpayers may consider requesting an Advance Pricing Agreement, which may run for multiple years.

For additional information call Henry Birnkrant (202-756-3319), Bob Cole (202-756-3306) or Brian Lebowitz (202-756-3394).

Jack Cummings
Editor

601 Pennsylvania Avenue, N.W.
North Building, 10th Floor
Washington, D.C. 20004-2601
202-756-3300
Fax: 202-756-3333

www.alston.com

I.R.S. Clarifies Rules for Interest Apportionment

Rev. Proc. 2003-37, 2003-21 I.R.B. 1, May 7, 2003

Overview

Revenue Procedure 2003-37 clarifies the requirements for using the fair market value method for apportioning interest under the foreign tax credit regime.

Background

In general, a taxpayer can claim a foreign tax credit for any foreign income taxes paid with respect to "foreign source" income. The maximum foreign tax credit is equal to the portion of the taxpayer's pre-credit U.S. income tax that is attributable to foreign source *net* income. In determining foreign source net income, a taxpayer must deduct expenses and losses properly allocable to foreign source income and a ratable share of expenses and losses that are not allocable to any single class of income (including interest).

Interest expense is generally apportioned between foreign and U.S. source income based on the tax basis of the taxpayer's assets. However, the regulations permit a taxpayer to elect to apportion interest based on the fair market value of its assets, provided the taxpayer establishes the fair market value of its assets "to the satisfaction of the I.R.S." Use of the fair market value method is advantageous for a U.S. taxpayer with appreciated U.S. assets because it will result in greater interest offsetting U.S. income, resulting in a higher foreign tax credit limitation.

New Rules

Prior to issuance of Revenue Procedure 2003-37, there was uncertainty as to when a fair market value election could be made and the documentation needed to substantiate the determination of fair market value. As a result, the fair market value method was not widely used. The new rules attempt to address these problems by making clear that the election can be made at any time and by establishing specific guidelines. A taxpayer must summarize how it determined the fair market value of its assets in a written statement that must include: (i) a description of all the taxpayer's assets; (ii) an explanation of how the assets are grouped under the expense allocation regulations; (iii) a description of valuation techniques used for tangible property; and (iv) a description of statistical methods used to value fungible property (such as commodities).

The consequences of having the information in the proper format depend on when the election is made. If the taxpayer makes the election within 90 days of the opening audit conference for the taxable year and furnishes the information in the proper format, the I.R.S. commits to promptly evaluate the fair market value election so that the audit cycle can be closed in the ordinary course. On the other hand, if the taxpayer makes the election at a later date or fails to furnish the information in the proper format, it appears that the I.R.S. intends to apply greater scrutiny.

Planning Considerations

Although a lot depends on how the I.R.S. interprets its "commitment" to promptly review the fair market value method election, Revenue Procedure 2003–37 appears to be a positive development and is an encouragement to use the fair market value method. The Revenue Procedure is generally effective for all open taxable years except taxable years currently under audit and for which the opening conference of the audit has occurred prior to June 7, 2003. Taxpayers with significant foreign tax credits not currently using the fair market value method should consider using the method in light of the Revenue Procedure. Taxpayers currently using the fair market value method who wish to continue using the method will need to determine what they have to do (if anything) to comply with the Revenue Procedure. Taxpayers under audit for prior taxable years should determine whether the Revenue Procedure is beneficial.

For additional information, contact Sam Kaywood (404-881-7481) or Kevin Rowe (212-210-9505).

International Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404-881-7481

Edward Tanenbaum
Co-Chair
212-210-9425

Pinney L. Allen
404-881-7485

Gideon T. J. Alpert
212-210-9403

Pamela S. Ammermann
202-756-3341

Saba Ashraf
404-881-7648

Henry J. Birnkrant
202-756-3319

Robert T. Cole
202-756-3306

Philip C. Cook
404-881-7491

James E. Croker, Jr.
202-756-3309

Jasper L. Cummings, Jr.
202-756-3386

Tim L. Fallaw
404-881-4479

Terence J. Greene
404-881-7493

Michelle M. Henkel
404-881-7633

L. Andrew Immerman
404-881-7532

Akemi Kawano
202-756-5588

Andrea M. Knight
404-881-4522

Andrea Lane
202-756-3354

Brian E. Lebowitz
202-756-3394

Timothy J. Peaden
404-881-7475

Kevin M. Rowe
212-210-9505

Matthew C. Sperry
404-881-7553

Joe T. Taylor
404-881-7691

Gerald Von Thomas II
404-881-4716

Charles W. Wheeler
202-756-3308