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The Case for Public Disclosure of Advance Rulings on Transfer Pricing Methodologies

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A dispute between the tax authorities and a multinational enterprise over transfer prices is a bit like a dispute among the would-be heirs of a multimillionaire who has died intestate. Both types of disputes can be long, drawn-out affairs, and much of the potential booty is often dissipated in legal fees and other litigation costs.

Consider, for example, the 14-year dispute over the distribution of the estate of the late Howard Hughes. I recently read in the paper that a settlement of his estate has been approved by the Chancery Court of Delaware. Hughes, an eccentric industrialist, died in 1976 without any obvious heirs. Actually, he may not have been intestate — several wills of dubious authenticity turned up. In any event, protracted litigation was needed to determine who was entitled to the estimated \$2 billion of assets in the estate. Incidentally, the settlement in Delaware does not close the estate. There are still legal issues to be resolved in the courts of California and Texas.

To determine the proper distribution of an estate, a probate court typically would apply a set of arcane legal rules to establish, in effect, the provisions of a will that the deceased might have written. In transfer pricing cases, the courts are also asked to play make-believe. Their job is to establish the prices for certain goods or services that would have prevailed in the marketplace if the multinational enterprise had made genuine sales of those goods or services.

An effective way to reduce disputes over the distribution of estates is for persons of wealth to write valid wills. The equivalent technique to circumscribe transfer pricing disputes is for multinational enterprises and the tax authorities to settle in advance on the appropriate methodology for determining the government's claims to tax revenue. Early this summer, the U.S. tax authorities announced that they would seek such agreements. A draft revenue procedure — which entered the public domain with an assist from TNI —

set forth general guidelines for taxpayers to follow in obtaining advance approval of their transfer [*1128] pricing methodologies. (See 2 TAX NOTES INT'L 545 (June 1990).) The latest word is that the official version of the revenue procedure will be issued within the next several months.

The ADR

Under the draft revenue procedure, a taxpayer wanting prospective approval from the IRS of its pricing methodology would submit a request for what the revenue procedure calls an "advance determination ruling" or ADR. That ruling request must be accompanied by a mountain of information about the taxpayer's pricing system. The IRS would study that information, assisted by an opinion rendered by a transfer pricing expert. The quasi-independent expert would be paid by the taxpayer and would be appointed with the joint approval of the taxpayer and the Service.

The basic idea of the ADR is sound. The best time to fight about pricing methodologies is before the competing interests of the potential antagonists have crystallized. Early resolution of methodological issues should save both sides some litigation costs. With their U.S. flank protected, moreover, a multinational enterprise should be able to do more effective tax planning outside the United States, thereby reducing the risk of double taxation.

Some international tax advisors have been complaining that the information requirements for a successful ADR request are excessive. There is little doubt that many potential applicants for an ADR, especially foreign taxpayers and relatively small domestic taxpayers, will be dissuaded from applying on account of those requirements. I assume, however, that the Service is not really anxious for a lot of early ruling requests. Its apparent strategy is to set up an advance ruling system for the really large multinational corporations, such as General Motors, and then see how the system works. If the system seems to be working well, then the IRS might consider whether it could relax some of the information requirements, thereby attracting more ADR requests, without compromising the system's integrity.

My initial problem with the draft revenue procedure was that it offered no guidance about the type of pricing arrangements likely to win IRS approval. There is language indicating that the IRS would accept pricing methods other than those set forth in the Treasury regulations under Code section 482. Indeed, the Service must be prepared to accept alternative pricing methods or the whole ADR process would be a joke. The Service presumably has some idea of the alternative pricing methods it would find acceptable, and I thought that it should communicate that information to the international tax community.

Going Public

At the time of the release of the draft revenue procedure, I was not too concerned about the lack of guidance on acceptable pricing methodologies because I expected that it would come in short order with the publication of the first wave of advance determination rulings. It seems clear that the IRS is having discussions with a few major companies about their pricing methodologies and that some agreements with these companies will be reached soon after the draft revenue procedure becomes final. The terms of these agreements would give the international tax community a pretty good idea of IRS policy.

To my amazement, the IRS recently indicated that it intends to keep the ADRs a secret. (See 2 *TAX NOTES INT'L* 1009 (October 1990).) ADRs, according to the IRS, will be treated like closing agreements. A closing agreement generally is considered to be part of a taxpayer's tax return and thus is not subject to disclosure under the Freedom of Information Act rules. A private letter ruling, in contrast, must be made public. I expect that the inevitable challenge to the Service's characterization of an advance determination ruling as something other than a ruling will end up in court and that the Service will end up on the losing side.

Even if the IRS position in favor of total secrecy can be sustained in the courts, it is an unwise position. I understand the legitimate concerns of the participants in the ADR process about secrecy. Surely it is generally appropriate — even required — that the Service keep sensitive details of a taxpayer's pricing strategy [*1129] out of the public domain. A need for some secrecy, however, does not justify total secrecy. Companies engaged in cross-border transactions ought to know the general guidelines that the IRS is following (implicitly or explicitly) in approving and disapproving the requests of their competitors for ADRs. And that information, which affects hundreds of millions of dollars in potential tax liability, should be available to U.S. treaty partners and to everyone concerned with the fair and efficient administration of U.S. tax laws. The only effective way to let interested parties know the legal standards governing the issuance of ADRs is to make sanitized versions of the ADRs available to the public.

Back in the days before the Service was forced by the courts (in a law suit initiated by Tax Analysts) to release private letter rulings to the general public, those rulings comprised the hidden tax law of the United States. That hidden law was available, of course, to employees of the IRS. It was also available, in substantial part, to some of the large law firms in such places as New York and Washington. Those firms naturally kept files of the many private rulings issued to their clients. Access to those files gave the privileged firms an advantage in practicing before the IRS — an unfair advantage in the view of practitioners without access to any letter ruling files. I assume that a similar bifurcation of the legal profession would take place if ADRs are kept secret. I really cannot see why the IRS would want to recreate such an unpleasant and unfair situation.

Playing Fair

I have two additional objections to a secret ADR process. First, the process already is quite unfavorable to foreign taxpayers. The draft revenue procedure, in its first paragraph, makes clear that foreigners can apply for an advanced ruling. But the rest of the document seems to assume that the taxpayer requesting a ruling would already be under an obligation to lay before the Service the details of its worldwide operations and the worldwide operations of the members of its corporate family. That is, it is drafted primarily to deal with the special transfer pricing problems of U.S.-based multinationals. It may be that foreign-owned subsidiaries cannot be tempted to participate in the ADR process. They surely will not be so tempted if the details of its operation are kept from them.

Second, a secret ADR process will weaken the prospects for international cooperation on transfer pricing issues. Such cooperation is essential to achieve greater uniformity in the rules governing the allocation of gross income and deductions. For example, the rules for allocating the deductions for interest, lease payments, and research and development expenditures vary widely from country to country. The international standards governing the allocation of gross income from intangible property are unrecognizable. I fear that a secret ADR process will contribute to a suspicion that the United States is seeking to maximize its tax revenues by fostering certain ad hoc departures from the arm's length standard. A public ruling process, in contrast, might be helpful in achieving some consensus on how governments should apply the arm's length standard in problem cases.

The IRS may have concluded that the ADR process would be unattractive to multinational companies unless the results of that process are kept secret. A hidden tax law, however, has no place in a democracy. If the IRS cannot find some way to bring the results of its ADR process under public scrutiny, it ought to abandon that process.