

Announcement 99-1

BACKGROUND

Rev. Proc. 65-17, 1965-1 C.B. 833, has been in place for more than 30 years and has been amended, amplified and clarified, and modified. The Internal Revenue Service intends to update its position with respect to the extent to which taxpayers whose income has been adjusted under section 482 of the Internal Revenue Code may make certain adjustments to conform their accounts to reflect the section 482 allocation.

Included with this announcement is the proposed update of Rev. Proc. 65-17. The Service wishes to receive comments from interested members of the public prior to publishing the final update.

Comments (eight copies) should be sent to Associate Chief Counsel (International) CC:INTL:FO, Internal Revenue Service, 1111 Constitution Avenue, NW, Room 3501, Washington, DC, 20224, making reference in the comments to Control Number RP-114650-97. To ensure that comments are given full consideration, they should be submitted by April 12, 1999.

The proposed revenue procedure makes a number of changes to the Service position published in several administrative pronouncements. See Rev. Proc. 65-17, 1965-1 C.B. 833; Rev. Proc. 70-23, 1970-2 C.B. 505; Rev. Proc. 71-35, 1971-2 C.B. 573; Rev. Rul. 82-80, 1982-1 C.B. 89. Generally, the proposed changes reflect the current policy under sections 482 and 6662(e) to foster taxpayers' upfront compliance with the arm's length standard in transfer pricing.

Among the significant changes, first, entitlement to treatment under Rev. Proc. 65-17 is dependent on a finding by the Service that the pricing transaction did not have as one of its principal purposes the avoidance of Federal income tax. The factual nature of the tax avoidance standard causes significant difficulty for both taxpayers and the Service. In its place, the proposed revenue procedure simply

requires that the taxpayer not be subject to a penalty under section 6662(e)(1)(B) or (h) of the Code by reason of the primary adjustment. This change focuses the inquiry on the objective adequacy of the taxpayer's documentation.

Second, cash repatriation treatment is extended to adjustments initiated by taxpayers pursuant to section 1.482-1(a)(3) of the Treasury Regulations, including downward as well as upward adjustments. The Service believes it appropriate to make revenue procedure treatment available for taxpayer-initiated adjustments only if the taxpayer complies with certain information reporting requirements as explained in section 5.02 of the proposed revenue procedure. Taxpayer-initiated adjustments for the treatment under the revenue procedure would be subject to review and adjustment, and to possible imposition of the section 6662(e) or (h) penalty, by the Service upon examination.

Third, the proposed revenue procedure eliminates dividend offset treatment. Dividend offset treatment is inconsistent with the current policy under sections 482 and 6662(e) that taxpayers should strive upfront to price their related party transactions in compliance with the arm's length standard.

The legislative history of the Revenue Reconciliation Act of 1993, P.L. 103-66, § 13236, evidences Congress' concern "about any case where a taxpayer uses related party transfer prices or other arrangements with no apparent consideration as to whether the taxable income reported, and the tax paid, conforms with the standards made applicable under section 482." H.R. Rep. 103-111, 103d Cong., 1st Sess. 719-20 (1993), 1993-3 C.B. 295-96. Accordingly, Congress incorporated contemporaneous documentation requirements into the statute under section 6662(e) so that a section 482 adjustment that exceeds the threshold generally should not escape the penalty "unless the taxpayer can show that the return position was arrived at after bestowing a reasonable amount of attention to the issue." *Id.* Congress underlined the seriousness of its concern that all taxpayers should comply upfront with the arm's length standard by lowering the threshold

for imposition of the penalty as well as by establishing an alternative threshold based on gross receipts. *Id.* See also H.R. Rep. No. 103-213 (Conference Report), 103d Cong., 1st Sess. 648-650 (1993), 1993-3 C.B. 526-28. See also Treas. Reg. § 1.6662-6(d)(2)(iii) and (3)(ii).

For those taxpayers that can benefit, the existence of the possibility of a dividend offset lessens the incentive built into the section 482 and 6662(e) regulations to comply upfront and conform their transfer pricing to the arm's length standard in the first instance, since they are able to mitigate the tax effect of non-arm's length pricing by means of the dividend offset. Moreover, allowing a dividend offset arbitrarily and unfairly places a taxpayer that received a dividend in the year of the adjustment in a better position with respect to a net adjustment than a taxpayer that did not receive a dividend in the year of the adjustment.

Further, while Rev. Proc. 65-17 may have been viewed as a means for obtaining "relief" from the consequences of an incorrect pricing policy and a section 482 allocation, that notion is not reflected in the proposed revenue procedure. The treatment provided by the revenue procedure will be available to all taxpayers, not just the taxpayers that by happenstance are able to offset a dividend by a section 482 allocation. Taxpayers will still be able to repatriate the amount of a primary adjustment by an account receivable and then reduce future dividend distributions accordingly.

Fourth, the proposed revenue procedure clarifies that a foreign tax credit is allowed for any foreign withholding tax with respect to the repayment of the principal or interest on a cash repatriation account to the extent and subject to the limitations provided under section 901 of the Code. The taxpayer would be obligated to exhaust all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, with regard to the imposition of the foreign withholding tax and the repayment of the principal of the account would not of itself create any section 904 limitation. See generally Treas. Reg. §§ 1.901-2(e)(5), 1.904-6(a)(1)(iv).

DRAFTING INFORMATION

The principal author of this announcement is W. Edward Williams of the Office of Associate Chief Counsel (International). For further information regarding this announcement contact Lisa G. Sams at (202) 874-1490 (not a toll-free call).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, section 482.)

Rev. Proc. 99-##

SECTION 1. PURPOSE.

This revenue procedure prescribes the applicable procedures for the repatriation of cash by a taxpayer via an interest-bearing account receivable or payable (the “account”) in an amount corresponding to the amount allocated to, or from, such taxpayer under section 482 of the Internal Revenue Code (the “Code”) from, or to, a related person. Under this revenue procedure, taxpayers whose income has been adjusted under section 482 of the Code are generally permitted to make certain adjustments to conform their accounts to reflect the section 482 allocation. The conditions for treatment under this revenue procedure are set forth in section 3, the adjustments to be made or allowed are described in section 4 (for Internal Revenue Service as well as taxpayer-initiated adjustments), and the prescribed procedures are set forth in section 5.

SEC. 2. BACKGROUND AND SCOPE.

Section 482 of the Code gives the Internal Revenue Service authority to “distribute, apportion or allocate gross income, deductions, credits, or allowances” among certain related organizations, trades or businesses if it “determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income” of any such entity. Absent a taxpayer’s election of treatment under this revenue procedure, an adjustment under section 482 (the “primary adjustment”) entails secondary adjustments to conform a taxpayer’s accounts to reflect the primary adjustment. These secondary adjustments may result in adverse tax conse-

quences to the taxpayer. For example, an allocation of income under section 482 from a foreign parent corporation to its domestic subsidiary corporation would entail a deemed distribution from the domestic subsidiary to its foreign parent in an amount equal to the primary adjustment in the year for which the allocation is made. The deemed distribution would be treated as dividend income to the foreign parent to the extent of the earnings and profits of the domestic subsidiary, as recomputed after taking into account the primary adjustment. Under section 881 of the Code, the foreign parent would be subject to a 30-percent tax liability (as reduced by any applicable income tax treaty), and under section 1442 of the Code, the domestic subsidiary would be a withholding agent required to withhold the tax. See Rev. Rul. 82-80, 1982-1 C.B. 89; Treas. Reg. § 1.1441-2(e)(2). This revenue procedure allows the taxpayer to repatriate the cash attributable to a primary adjustment via an account without the Federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment.

Additionally, section 1.482-1(a)(3) of the Income Tax Regulations permits a controlled taxpayer to report an arm’s length result for controlled transactions based upon prices different from those actually charged. If the adjustment results in an increase in income, the increased income may be reported by the taxpayer at any time. If the adjustment results in a decrease in income (after appropriate accounting for section 1059A of the Code), the arm’s length result may be reported on a timely filed return (including extensions). A taxpayer can avail itself of the treatment provided by this revenue procedure to mitigate the Federal income tax consequences of the secondary adjustments that would otherwise be entailed as a result of the taxpayer’s “self-initiated” primary adjustment. The taxpayer-initiated adjustment for the treatment provided under the revenue procedure will be subject to review and adjustment, and to possible imposition of the section 6662(e) or (h) penalty, by the Service upon examination.

This revenue procedure applies in situations where an adjustment is made under section 482 of the Code, as well as to ad-

justments made under sections 61 or 162 of the Code provided the adjustment could have been made under section 482 of the Code. All references in this revenue procedure to section 482 of the Code will be deemed to include sections 61 and 162 of the Code, except when the context or express language indicates or provides otherwise.

Any reference in this revenue procedure to an increase, or decrease, in taxable income shall also be deemed a reference, in an appropriate case, to a reduction, or increase, in a taxpayer’s loss.

Any reference in this revenue procedure to the Service shall be deemed a reference to the District Director of Internal Revenue Service or a reference to the Assistant Commissioner (International), depending on the office that has jurisdiction over the Federal income tax return filed for the taxable year for which the primary adjustment is made.

SEC. 3. CONDITIONS FOR TREATMENT UNDER THIS REVENUE PROCEDURE.

A taxpayer shall qualify for the treatment provided in this revenue procedure only if it satisfies the conditions described in this section 3.

.01 The treatment provided in this revenue procedure is available if the taxable income of such taxpayer is adjusted by the Internal Revenue Service under section 482, or by the taxpayer pursuant to section 1.482-1(a)(3) of the regulations, and the taxpayer is not subject to a penalty under section 6662(e)(1)(B) or (h) of the Code by reason of the primary adjustment that is the basis for the treatment under this revenue procedure.

.02 A taxpayer shall not qualify under section 3.01, above, for the treatment provided in this revenue procedure if any part of any underpayment of tax by such taxpayer for the taxable year involved in the section 482 allocation is due to fraud.

SEC. 4. ADJUSTMENTS TO BE MADE OR ALLOWED

.01 *Account, interest and payment.* If a taxpayer qualifying under section 3, above, complies with the requirements of section 5, below, such taxpayer may be permitted to establish an interest-bearing account receivable from, or payable to,

the related person from, or to, whom the section 482 allocation is made in an amount equal to the primary adjustment for each of the years in which an allocation is made. The account may be established and paid in accordance with this revenue procedure without the Federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment. The account shall:

1 be deemed to have been created as of the last day of the taxpayer's taxable year for which the primary adjustment is made;

2 bear interest at an arm's length rate, computed in the manner provided in section 1.482-2(a)(2) of the regulations, from the day after the date the account is deemed to have been created to the date of payment. The interest so computed shall be accrued and included in, or deducted (subject to applicable limitations) from taxable income for each taxable year during which the account is deemed outstanding;

3 must be paid within the 90-day period required in section 5, below. Payment must be in the form of money, a written debt obligation payable at a fixed date and bearing interest at an arm's length rate determined in the manner provided in section 1.482-2(a)(2) of the regulations, or an accounting entry offsetting such account against an existing debt between the taxpayer and the related person.

A foreign tax credit shall be allowed for any foreign withholding tax with respect to the repayment of the principal or interest of the account to the extent and subject to the limitations provided under section 901 of the Code. See Treas. Reg. §§ 1.901-2(e)(5) and 1.904-6(a)(1)(iv).

.02 *Primary adjustment not affected.* A taxpayer's election to avail itself of the provisions of this revenue procedure shall in no way affect the primary adjustment under section 482 of the Code. Such election shall, however, affect the taxpayer's taxable income and credits to the extent indicated by section 4.01 above, and eliminate the collateral effects of secondary adjustments described in section 2 above.

SEC. 5. PROCEDURES TO BE FOLLOWED.

.01 *Cases pending with the Internal Revenue Service.*

1 If a United States taxpayer whose income has been adjusted by the Internal Revenue Service pursuant to section 482 of the Code desires to avail itself of the treatment provided in section 4, above, it must file a request in writing with the Service before closing action is taken on the primary adjustment. The request shall be signed by a person having the authority to sign the taxpayer's Federal income tax returns, and shall contain the following:

(a) A statement that the taxpayer desires the treatment provided by section 4 of this revenue procedure and the years for which the treatment is requested;

(b) A description of the arrangements or transactions, or the terms thereof, which gave rise to the primary adjustment;

(c) A statement that the applicable conditions set forth in section 3 are met, and that the taxpayer will cooperate fully with the Service in providing evidence supporting such statement;

(d) An offer to enter into a closing agreement under section 7121 of the Code as provided in section 5.013, below.

2 The Service will determine whether the taxpayer qualifies for the requested treatment and inform the taxpayer of its decision.

3 If the Service concludes that section 4 of this revenue procedure properly applies, and if the amount of the primary adjustment has been agreed upon, the taxpayer will be requested to enter into a closing agreement under section 7121 of the Code, establishing for each year involved:

(a) The amount of the primary adjustment;

(b) The amount of the account which the taxpayer elects to establish under section 4.01, above;

(c) The amount of the interest on the account includible in income, or deductible, pursuant to section 4.01, above;

(d) The amount of any foreign tax credit that taxpayer will claim under section 901 of the Code with respect to payment of the principal or interest on an account established pursuant to section 4.01, above;

(e) The manner of payment of the account pursuant to section 4.01, above, and the taxpayer's right to receive or make

such payment free of the Federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment, provided such payment is made within 90 days after execution of the closing agreement on behalf of the Commissioner.

.02 *Cases of a taxpayer reporting an adjustment pursuant to section 1.482-1(a)(3) of the regulations.* If a United States taxpayer that has increased or decreased its taxable income pursuant to section 482 and section 1.482-1(a)(3) of the regulations desires to avail itself of the treatment provided in section 4, above, it must file a statement with its Federal income tax return reporting the primary adjustment. The statement shall contain the following:

1 A statement that the taxpayer desires the treatment provided by section 4 of this revenue procedure for the years indicated;

2 A description of the arrangements or transactions, or the terms thereof, which gave rise to the primary adjustment;

3 A statement that the applicable conditions set forth in section 3 are met, and that the taxpayer will cooperate fully with the Service in providing evidence supporting such statement;

4 The amount of the primary adjustment;

5 The amount of the account which the taxpayer elects to establish under section 4.01, above;

6 The amount of interest on the account includible in income, or deductible, pursuant to section 4.01, above, and the years of such inclusion or deduction;

7 The amount of any foreign tax credit that taxpayer will claim under section 901 of the Code with respect to payment of the principal or interest on an account established pursuant to section 4.01, above;

8 The manner of payment of the account pursuant to section 4.01, above, which shall be free of the Federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment, provided such payment is made within 90 days of the date on which the taxpayer files the return reporting the primary adjustment.

.04 *Cases pending before the Tax Court of the United States.* If a case reaches trial status in the Tax Court and it is determined that the taxpayer is entitled to the treatment provided in section 4, above, the parties may stipulate or otherwise arrange with the Court so that any adjustment in tax for the years before the Court will reflect the application of section 4, above, provided the taxpayer executes the required closing agreement.

.05 *Cases within the jurisdiction of the Department of Justice.* If a taxpayer files with the Service a request for treatment under section 4, above, with respect to a case within the jurisdiction of the Department of Justice, the Service, through its Chief Counsel, will recommend to the Department of Justice the action to be taken with respect to the taxpayer's request.

SEC. 6. EFFECTIVE DATE.

This revenue procedure is effective for taxable years beginning after [ENTER DATE OF PUBLICATION OF THIS REVENUE PROCEDURE AS A FINAL DOCUMENT].

SEC. 7. EFFECT ON OTHER DOCUMENTS.

Rev. Proc. 65-17, 1965-1 C.B. 833, as amended by Rev. Proc. 65-17 (Amend. I), 1966-2 C.B. 1211 and Rev. Proc. 65-17 (Amend. II), 1974-1 C.B. 411, is superseded. Rev. Proc. 70-23, 1970-2 C.B. 505, Rev. Proc. 71-35, 1971-2 C.B. 573, Rev. Proc. 72-53, 1972-2 C.B. 833 and Rev. Rul. 82-80, 1982-1 C.B. 89, are superseded. Rev. Proc. 72-22, 1972-1 C.B. 747, and Rev. Rul. 69-630, 1969-2 C.B. 112 are modified and the references to Rev. Proc. 65-17 therein shall be treated as references to this revenue procedure. The references to Rev. Proc. 65-17 in Rev. Proc. 65-31, 1965-2 C.B. 1024, Rev. Proc. 68-16, 1968-1 C.B. 770, Rev. Proc. 72-46, 1972-2 C.B. 827, Rev. Proc. 72-48, 1972-2 C.B. 829, Rev. Proc. 89-8, 1989-1 C.B. 778, Rev. Proc. 96-13, 1996-1 C.B. 616, Rev. Proc. 96-14, 1996-1 C.B. 626, and Rev. Proc. 96-53, 1996-2 C.B. 375, shall be treated as references to this revenue procedure.

SEC. 8. DRAFTING INFORMATION.

The principal author of this Revenue Procedure is W. Edward Williams of the

Office of the Associate Chief Counsel (International). For further information on this revenue procedure, contact Lisa G. Sams at 202-874-1490 (not a toll-free call) or write to CC:INTL:Br6, Room 3319, 950 L'Enfant Plaza South, S.W., Washington, D.C. 20024.

SEC. 9. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure will be submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(c)).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information in this revenue procedure is in section 5. This information is required to determine whether a taxpayer that has made a primary adjustment under section 482 of the Code will be permitted to make certain adjustments to conform their accounts to reflect the section 482 allocation. The collections of information are required for a taxpayer to obtain the Commissioner's permission to repatriate the cash attributable to a primary adjustment via an account without the Federal income tax consequences of the secondary adjustments that would otherwise be entailed as the result of the primary adjustment. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 1620.

The estimated annual burden per respondent/recordkeeper varies from 8 hours to 10 hours depending on individual circumstances, with an estimated average of 9 hours. The estimated number of respondents and/or recordkeepers is 180.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.