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## Avoidance of International Double Taxation Arising From Section 482 Reallocations†

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### I

In the jargon of the tax executive of a United States corporation, among the words of horror are "we have a section 482 problem."<sup>1</sup> Section 482 is an *in terrorem* provision of the Internal Revenue Code intended to give the Internal Revenue Service a tool to prevent tax avoiding business manipulations between related corporations.<sup>2</sup> The Service can use it to reallocate the income and deductions of two related corporations so that the net result, in theory at least, will be the same as if the transactions were between entirely independent entities.

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1. INT. REV. CODE OF 1954, § 482, *Allocation of Income and Deductions Among Taxpayers*.

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 or his delegate 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 prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The Internal Revenue Code of 1954 is hereinafter cited as IRC and referred to in text as the Internal Revenue Code or the Code. The Internal Revenue Service may be sometimes identified only as the Service or the IRS.

2. Section 482 is not confined to corporations, but its application is usually in the corporate field. Treas. Reg. § 1.482-1(a)(1) (1962, *as amended*, 1968).

Nearly every country has provisions in its tax laws which are similar to section 482 or achieves reallocation under the general rules relating to the determination of income.<sup>3</sup> The authority to reallocate given to the United States Internal Revenue Service is very broad, however, and has been extended to a great variety of adjustments.<sup>4</sup> The United States apparently has more detailed guidelines for reallocation than most other countries.<sup>5</sup>

There are numerous situations that might prompt a section 482 reallocation between a United States corporation and a related foreign entity. For example, assume corporation X, a United States corporation, has a wholly owned foreign subsidiary Y. X sells its products to independent distributors at cost plus 20 percent, while it sells them to Y at cost plus 10 percent; or X sends its top sales personnel to assist Y in merchandising the product and makes no charge to Y for this service; or X loans Y a million dollars without any interest charge; or X licenses Y to use patents owned by X without royalty. The result of a section 482 reallocation in these situations may be additional net income allocated to the United States corporation and additional United States tax liability.

Although a provision for reallocation of income or deductions has been in the Internal Revenue Code since the Revenue Act of 1928, it was little used in the international field prior to the 1960's.<sup>6</sup> Even domestically the Service made comparatively little use of the section after some early judicial opinions placed definite limits on its application.<sup>7</sup> This domestic neglect was reversed, however, after the Service obtained some favorable decisions in the 1950's.<sup>8</sup>

Two factors brought about the increased attention to the question of income and deduction allocation in international transactions. First, in 1961 the Service started a more aggressive enforcement program called the "International Enforcement Program" or the "Coordinated Examination Program." Its purpose was to increase the level of voluntary compliance with the international transaction tax rules by an in-

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3. SURREY & TILLINGHAST, GENERAL REPORT, CAHIERS DE DROIT FISCAL INTERNATIONAL I/7-10 (1971).

4. See, e.g., *B. Foreman Co. v. United States*, 453 F.2d 1144 (2d Cir. 1972) (imputed interest income on loans made to controlled corporation allocated between lenders).

5. SURREY & TILLINGHAST, GENERAL REPORT, CAHIERS DE DROIT FISCAL INTERNATIONAL I/10 (1971).

6. See *Eli Lilly & Co. v. United States*, 372 F.2d 990 (Ct. Cl. 1967); *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233 (Ct. Cl. 1969).

7. *Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F.2d 508 (6th Cir. 1940); *Smith-Bridgman & Co.*, 16 T.C. 287 (1951).

8. *Advance Machinery Exch., Inc.*, 196 F.2d 1006 (2d Cir. 1952); *Aldon Homes, Inc. v. Commissioner*, 33 T.C. 582 (1959).

tensive and extensive audit procedure that teamed a district agent with an international specialist.<sup>9</sup> The section 482 audit program now uses this "team audit" concept extensively.<sup>10</sup>

The second factor was the change in United States policy towards foreign investment in the early 1960's. Before 1961 the policy of the national administration was to encourage United States nationals, both individual and corporate, to invest in foreign country operations. When the Kennedy administration took office, the increasing trade balance deficit caused it to seek methods to stem the flow of capital from the United States,<sup>11</sup> and in 1962 the administration requested Congress to make substantial changes in the Internal Revenue Code, in part to achieve this purpose.<sup>12</sup> The Treasury stated at the time that one of its proposals would materially increase its ability to meet problems of improper allocation of income and deductions between related organizations which it contended had major effects on revenue. Although the House adopted an amendment to section 482, that to some extent fulfilled the Treasury request, it was rejected by the Senate and no change was made in the section by the Revenue Act of 1962. The House Committee stated, however, that the Treasury had sufficient tools to meet the problems and encouraged it to promulgate new regulations under section 482, "which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income."<sup>13</sup>

The Treasury took this suggestion as a mandate to promulgate very extensive new regulations calculated to function as guidelines for transactions involving controlled entities.<sup>14</sup> With these new regulations as their basic weapon, the audit group that was first activated in 1961 had a potent tool for use in conjunction with the audit of international transactions. With some limitations that will be discussed hereafter,<sup>15</sup> the new regulations were made fully retroactive.<sup>16</sup> As a result, there

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9. Thrower, *Recent Developments in International Tax Administration and Enforcement*, 1 TAX ADVISOR 479, 482 (August 1970). In 1965 the Service also decentralized the responsibility for international transaction audits to the district level.

10. *Id.*

11. Slowinski, *Federal Taxation and Foreign Policy*, 20 U. FLA. L. REV. 489, 492 (1968).

12. Federal Tax System—Message from the President of the United States, 107 CONG. REC. 6456, 6458 (1961).

13. H.R. REP. NO. 2508, 87th Cong. 2d Sess. 18-19 (1962).

14. Control, as defined for the purpose of Section 482, is extremely broad including "any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise." Treas. Reg. 1.482-1(a)(3) (1962), *as amended*, 1968).

15. See text accompanying notes 59-71 *infra*.

16. Rev. Proc. 64-54, 1964-2 CUM. BULL. 1008, 1012.

has been extensive use of this newly enunciated power of the Commissioner. In 1968 there were approximately 1,000 cases involving proposed adjustments under section 482, and the examining agents proposed 886 adjustments out of 1,700 possible adjustments.<sup>17</sup> Typical of the adjustments proposed are those arising out of sales by a United States parent to its foreign subsidiary when the sale by the parent is at a different price from that charged to independent vendees. In such a situation the examiner may determine that the price was not the result of an arm's length transaction and propose an adjustment based upon one of the formulae set forth in the section 482 regulations.

The simple and usual result of a section 482 adjustment is a change in the Federal income tax paid by the United States organization because its taxable income has increased or decreased. The results may be more complex and costly, however. For example, an adjustment can mean the loss of the benefits of being a Western Hemisphere Trade Corporation by reducing the proportion of gross income from sources outside the United States and within the Western Hemisphere below the required 95 percent.<sup>18</sup> An adjustment may also have a material effect on the corporation by reason of the Internal Revenue Code provisions dealing with controlled foreign corporations.<sup>19</sup> Further, the Internal Revenue Service has taken the position that when an adjustment under section 482 has been made, all correlative adjustments must also be made, which may add substantial complexity to the situation.<sup>20</sup> The I.R.S. also may determine that a constructive dividend was paid to a common related entity when brother-sister corporations are involved.<sup>21</sup> Finally, although not necessarily the most costly, but in all probability the most irritating and burdensome to the United States taxpayer, there is the possibility of double taxation.

When an adjustment results, as it usually does, in increased United States income tax, a correlative adjustment for the foreign entity may

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17. Address by Robert T. Cole, International Tax Counsel, Treasury Department, to the Los Angeles Bar Association, April 22, 1971. Discussion with attorneys representing large corporations indicates that the revenue agent in the field pays only lip service to the regulations and settles most cases on what would be termed a "horsetrade" basis.

18. IRC § 921.

19. IRC §§ 954(b)(3)(4), 955(c)(1); O'Connor, *Side Effects of Section 482 Can Be More Serious than Original Allocation*, 31 J. TAXATION 194, 194-96 (1969).

20. Treas. Reg. 1.482-1(d)(2) (1962, as amended, 1968); Rev. Proc. 65-31, 1965-1 CUM. BULL. 1024-26; Farber, *The Less Developed Area of Correlative Adjustments Under Section 482*, 45 TAXES 811 (1967).

21. Rev. Rule 69-630, 1969-2 CUM. BULL. 112; Jenks, *Constructive Dividends Resulting from Section 482 Adjustments*, 24 TAX LAWYER 83 (1970).

be difficult, and sometimes impossible,<sup>22</sup> to obtain, which means that the same income is taxed by both countries. The problem of double taxation caused by section 482 reallocations is really only part of the general problem of proper allocation of income and expenses between related entities in different countries. The methods of double taxation relief discussed in Part II are primarily aimed at this broader problem. For section 482 adjustments, however, the problem is even more critical than in the typical international allocation situations because, as noted above, it is usually an after-the-fact adjustment; the foreign tax has already been paid and will not or cannot be refunded. Because the income allocated to the foreign affiliate decreases while the tax levied on it stays the same, the effective foreign tax rate may be close to confiscatory.<sup>23</sup> Of course, this confiscatory rate applies only to the income that is reallocated among the related entities. This is not an insignificant amount, however; in a recent year the income reallocated to United States corporations is reported to have exceeded 250 million dollars.<sup>24</sup>

The possibility of such a heavy tax impact is obviously an inducement to conduct transactions among related entities on a strictly arm's-length basis, and an argument can be made that those who fail to meet that standard should do so at their own risk. If we look only at the revenue-raising function of United States taxation of international operations, such a position can easily be justified. However, this fails to take into account the effect double taxation can have on the competitive position of United States industries in the world market. Furthermore, there is some merit to the argument that relief from United States taxes that would result in double taxation could ultimately increase the total United States tax revenue.

It is this writer's opinion, however, that there is no justification for favorable tax treatment of foreign income. If the United States wishes to subsidize foreign investment, the tax laws should not be the vehicle. The goal in our examination of taxation of multinational business should be to find a rational system under which United States business operations in the international market can bear their fair share of the taxes imposed by the concerned jurisdiction, and at the same time preserve their ability to compete favorably with domestic or for-

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22. This may occur when the adjustment is of an item which under the tax law or administrative rules of the foreign country is not subject to a correlative adjustment. Miller, *Proposals for Amelioration of Section 482 Allocations Affecting U.S. Taxpayers with Foreign Affiliates*, 44 TAXES 209, 214 (1966).

23. This problem is partially alleviated by the United States tax credit given for foreign taxes paid. See text accompanying notes 28-34 *supra*.

24. Thrower, *supra* note 9.

aign industry. The purpose of this Article is to examine the means by which this end currently may be achieved after a section 482 reallocation.

## II

### A BRIEF SURVEY OF DOUBLE TAXATION RELIEF

The twentieth century brought a tremendous increase in international economic activity. At the same time tax systems began to take on layers of sophistication. The possibility of the same income being taxed by two or more jurisdictions came to be a matter of concern to both entrepreneurs and governments.<sup>25</sup> The easy solution was for a country to take unilateral action for relief of double taxation. Another solution was to endeavor to arrive at bilateral or multilateral agreements limiting the jurisdiction of each country to tax specified categories of income or taxpayers.

Using the unilateral approach a country normally either exempted foreign income or categories thereof from the measure of its tax, or gave a credit against the tax liability owed it to the extent of the foreign tax or some portion thereof. In the United States the exemption alternative never received serious consideration because the global system of taxation—taxing all income of citizens and residents regardless of its geographic source<sup>26</sup>—is too deeply ingrained in our tax system.<sup>27</sup> The United States has consistently taken the position that although the country of source has the right to tax income attributable to activities within or related to it, the income of United States citizens and resident aliens is still subject to its taxing jurisdiction and must be included in reportable gross income.

Since 1918, however, a tax credit for foreign taxes paid by United States taxpayers has been in our tax code.<sup>28</sup> The original tax credit provision was unsophisticated by modern standards. Its basic defect

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25. For a general discussion of the bases for asserting jurisdiction to tax, and the problems involved when different jurisdictions apply inconsistent bases, see Bloch & Heilemann, *International Tax Relations*, 55 YALE L.J. 1158 (1946); Norr, *Jurisdiction to Tax and International Income*, 17 TAX L. REV. 431 (1962).

26. The Internal Revenue Code contains some specific exemptions or exclusions from this policy, e.g., IRC § 911, and a taxpayer may take a deduction for foreign taxes, IRC § 275. This is done only infrequently by taxpayers.

27. The International Chamber of Commerce argues that an exemption, rather than a tax credit, in the country of the taxpayer's residence is the only sure method of avoiding double taxation of foreign source income owing to differences in the types of taxes levied in the interested countries, and in the bases of assessment of income taxes, and to the existence of subordinate taxing authorities. INTERNATIONAL CHAMBER OF COMMERCE, *AVOIDANCE OF DOUBLE TAXATION: EXEMPTION VERSUS TAX-CREDIT METHOD* 6-7, 12-16 (1955).

28. Revenue Act of 1918, ch. 18, §§ 222(a)(1), 238(a), 40 Stat. 1073, 1080 (relating to individuals and corporations, respectively).

was that it placed no limit on the amount of credit allowable, and a taxpayer operating in a foreign country having a tax rate substantially higher than that of the United States might obtain a credit that would materially reduce or eliminate the United States tax on his domestic income. This loophole was closed by amendments in 1921<sup>29</sup> and 1932.<sup>30</sup> While the present version of the tax credit<sup>31</sup> is in some respects more liberal than the 1932 provision, it also provides limitations against possible abuse.<sup>32</sup>

In some instances the tax credit is available to avoid the double taxation impact that might result from a section 482 reallocation. However, the effectiveness of the credit is curtailed by the limitations on the amount of foreign taxes creditable against the United States tax.<sup>33</sup> Under section 904 the credit is limited to that percentage of the United States tax which the corporation's foreign income bears to its worldwide income. If foreign income is ten percent of worldwide income, the tax credit cannot be in excess of ten percent of the United States tax computed before the credit. Moreover, the maximum creditable rate is equal to the effective United States rate. If the actual foreign tax rate or the effective rate after a section 482 reallocation is greater than the United States rate, the foreign tax on the income will not be completely creditable. Another limitation on the ameliorative effect of the tax credit is the provision restricting the credit allowed to corporate shareholders.<sup>34</sup> To get the credit, they must own at least a ten percent interest in a foreign subsidiary, and the credit for foreign taxes paid by the subsidiary cannot exceed the dividends received by the parent from the subsidiary in the year of the credit.

Unilateral relief such as the tax credit is not the only available remedy for double taxation, however. Unilateral relief means the United States bears the entire burden of the alleviation of double taxation by allowing a credit for taxes paid to a foreign country regardless of its determination of the status of the income involved. A more equitable method would be the execution of bilateral or multilateral agreements under which each country yields a portion of its power to tax.

The consideration of bilateral or multilateral treaties as a means of preventing double taxation of international business is not, of course, a development incident to the fairly recent changes in enforcement of

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29. Revenue Act of 1921, ch. 136, §§ 222(a)(5), 238(a), 42 Stat. 249, 258.

30. Revenue Act of 1932, ch. 209, § 131(b), 47 Stat. 211.

31. IRC §§ 901-06.

32. See generally Comment, *The Limitless Limits of the Foreign Tax Credit*, 45 WASH. L. REV. 347 (1970).

33. IRC § 904.

34. IRC § 902.

domestic law governing allocations of income and deductions. In the 1920's the interest of the League of Nations in the subject was stimulated by the International Chamber of Commerce, and several League committees studied the problem.<sup>35</sup> A model bilateral income tax convention was drafted by the League Finance Committee and adopted in 1928.<sup>36</sup>

The 1928 Model Bilateral Convention is of interest because of its provisions concerning allocations among related taxpayers. Although the Model Convention and those coming out of the League in 1943 (Mexico) and 1946 (London) were not widely accepted, they did establish a pattern of dealing with allocations among controlled entities which has not changed materially since 1928. The 1928 Convention contained provisions for agreement between the fiscal authorities in each of the involved states to determine the appropriate division of profits between the home office and the permanent foreign establishment.<sup>37</sup> Although during the debate on this provision the view was expressed that it should only be applicable when there were no appropriate accounts, this was rejected.<sup>38</sup> The prevailing opinion in the Finance Committee was that reliance on accounts could lead to a unilateral change by one country which might result in disagreement, and that the best solution was to allow the fiscal authorities to agree to a fair division of profits irrespective of the accounts. Although there was some suggestion that the convention should specifically set forth the rules of apportionment, the final decision was that these should be worked out by a permanent organization.<sup>39</sup>

When the permanent Fiscal Committee of the League of Nations considered allocations between the home office and its permanent establishment in another country, it decided the allocations should, as far as possible, be determined on the basis of the books of account with verification on the basis of local factors. Essentially, the concept adopted was to allocate that income to the permanent foreign establishment which it would have been expected to earn had it been an independent entity.<sup>40</sup> If accounts were not available, then the fiscal authorities could allocate by comparison with the earnings of similar enterprises within the state, or, if this were not feasible, on a multi-factor formula similar to that presently used by many of the states in

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35. A. EHRENZWEIG & F. KOCH, *INCOME TAX TREATIES* 6 (1950).

36. M. CARROLL, *PREVENTION OF INTERNATIONAL DOUBLE TAXATION AND FISCAL EVASION: TWO DECADES OF PROGRESS UNDER THE LEAGUE OF NATIONS* 21 (1939).

37. J. HERNDON, *RELIEF FROM INTERNATIONAL INCOME TAXATION* 203-04 (1932).

38. *Id.*

39. *Id.*

40. M. CARROLL, *supra* note 36, at 28-30.



the United States to allocate income of a multi-state enterprise.<sup>41</sup> The guiding principle was that the permanent foreign establishment was to be treated as if it were an independent legal entity doing business with the rest of the enterprise on an arm's-length basis.

The 1928 Convention also provided a procedure for adjudication of disputes arising between the fiscal authorities of the two states. Under this procedure the dispute was to be submitted to a technical body to be appointed by the Council of the League of Nations. This decision was not necessarily binding because the parties themselves determined the extent to which they would be bound. They were also free to pursue any other avenue of settlement, including taking the matter before the Permanent Court of International Justice if it were within the jurisdiction of that body.<sup>42</sup>

After the demise of the League of Nations, its work in the area of double-taxation agreements was carried on by the Organization for European Economic Cooperation (OEEC) through its Fiscal Committee. During the period 1958 to 1961 the Committee issued four reports which together embodied a draft double-taxation convention. In 1961 the Organisation for Economic Co-operation and Development (OECD), which was the successor to the OEEC, adopted and expanded the work previously done by the OEEC.<sup>43</sup> Many of the new articles in the OECD draft were concerned with the allocation of income among related parties.

Article 7, paragraph 2 provides that income of a permanent establishment<sup>44</sup> shall be computed on the basis of its being "a distinct

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41. *E.g.*, CAL. REV. & TAX CODE §§ 25101-28 (West 1970).

42. J. HERNDON, *supra* note 37, at 226.

43. Kragen, *Double Income Taxation Treaties: The OECD Draft*, 52 CALIF. L. REV. 306 (1964).

44. *Id.*

Article 5—Permanent Establishment.

1. For purposes of this Convention, the term "permanent establishment" means a fixed place of business in which the business of the enterprise is wholly or partly carried on.

2. The

- a) place of management;
- b) a branch;
- c) an office;
- d) a factory;
- e) a workshop;
- f) a mine, quarry or other place of extraction of natural resources;
- g) a building site or construction or assembly project which exists

for more than twelve months.

3. The term "permanent establishment" shall not be deemed to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

and separate enterprise engaged in the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."<sup>45</sup> Paragraphs 3 and 4 of the same article temper this somewhat by allowing an apportionment of total profits, provided it is in accordance with the principles of the convention.<sup>46</sup>

Allocations among associated enterprises are covered by article 9 of the draft.<sup>47</sup> The comment to this article<sup>48</sup> makes it clear that rectification of the accounts is to be made only when they do not show true taxable profits in the contracting state. The comment does not state what "true taxable profits" are but, referring to the comment to paragraph 2 of article 7,<sup>49</sup> the standard to be applied should be that

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL 43-44 (1963) (Doc. C(63) 87) [hereinafter cited as OECD DRAFT].

45. *Id.* at 46.

46. 3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles laid down in this article.

*Id.*

47. Article 9—Associated Enterprises

Where

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

OECD DRAFT, *supra* note 44, at 47.

48. *Id.* at 93.

49. *Id.* at 82.

of an independent and separate enterprise dealing with an unrelated entity. Article 25<sup>50</sup> sets forth a mutual agreement procedure for resolving disputes over the proper allocation of profits among associated enterprises. Since this provision is very similar to the competent-authority provision in most United States bilateral treaties, it will be discussed below in the section dealing with the competent authority.<sup>51</sup>

During this period of development of model bilateral conventions, most of the industrial countries of Western Europe and the United States were involved in extended negotiations leading to the execution and ratification of bilateral treaties. The United States is party to over 24 income tax treaties, while other countries, such as Sweden, have executed many more. At the outset, the treaties entered into by the United States were with nations of Western Europe, starting with France in 1932.<sup>52</sup> In the late 1960's the United States began its negotiations for treaties with less developed nations, but this has been a slow and frustrating process.

The question of allocation of profits has had only secondary consideration in the treaties, however, as it did in the OECD Model Convention, because the primary purpose of both has been to bring about internationally accepted rules respecting the determination of the source of income.<sup>53</sup> A good example of the treatment of the allocation issue in the United States treaties is found in the treaty with the United Kingdom which served as a model for other conventions entered into in the late 1940's and 1950's.<sup>54</sup> The treaty provides for the allocation to a permanent establishment of the profits which it would have earned had it been an independent entity. The treaty also recognizes that if the accounts are rectified in one state, a corresponding adjustment should be made in the accounts of the enterprise in the other state.<sup>55</sup> The treaty provides for the use of a multifactor formula as a method of allocating profits in the absence of accounts.<sup>56</sup> As for the allocation of profits of controlled enterprises, article 4 of the United Kingdom treaty<sup>57</sup> contains a provision which was quite similar to that found in article 9 of the OECD draft.<sup>58</sup> This provision is obviously intended to place controlled taxpayers on a parity with independent enterprises. The early version of the treaty with the United Kingdom did not

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50. *Id.* at 56.

51. See text accompanying notes 89 and 96 *infra*.

52. A. EHRENZWEIG & F. KOCH, *supra* note 35, at 12.

53. See Gordon, *The Role of Tax Treaties*, 43 TAXES 463, 465 (1965).

54. A. EHRENZWEIG & F. KOCH, *supra* note 35.

55. F. KOCH, *THE DOUBLE TAXATION CONVENTIONS* 64 (1947).

56. *Id.* at 65.

57. *Id.* at 66-67.

58. See note 47 *supra*.

contain a requirement of correlative adjustments in the case of allocation. The United Kingdom protocol of April 17, 1966 remedied this by the insertion of a new article 20A. Substantially all of the income tax treaties entered into by the United States now provide for fiscal collaboration between the two countries to handle the various adjustments which the application of the treaty provisions brings about.

Despite these various remedies for the avoidance of double taxation, the experience in the 1960's was that they did not meet the problem resulting from the increased application of section 482. In considering the possibility of additional unilateral relief, however, the Internal Revenue Service was faced with a dilemma. The expanded application of section 482 resulted in the collection of revenue to which the Service believed the United States was entitled. In a substantial number of cases, however, the taxpayer was subjected to double taxation, a result repugnant to both the taxpayer and, theoretically at least, the Service. Either the other country involved refused to grant a refund which it should have given, or its tax system made no provision for a refund.<sup>59</sup> The Treasury had to choose whether to let the chips fall where they might, give a full offset for any foreign tax that was attributable to reallocated income, or take some compromise position.

The Treasury chose a middle ground which it embodied in Revenue Procedure 64-54.<sup>60</sup> It recognized that the accelerated enforcement of section 482 had resulted in additional tax for a substantial number of taxpayers whose allocations of income or deductions had been arrived at in good faith and whose actions were not motivated by tax considerations. Section 482 had not been enforced to any real extent previously and there had been no guidelines for taxpayers to follow. In fact, even after reallocations were beginning to be proposed by the Internal Revenue Service, there were no published guidelines.

Revenue Procedure 64-54 attempted to deal with this situation by providing an offset against the increased United States tax resulting from the reallocation.<sup>61</sup> The offset was to be "equal to the amount by which the controlled foreign entity's foreign income tax liability as actually determined exceeded the amount which would have been determined to be such liability if the controlled foreign entity had

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59. Tillinghast, *The Position of the Treasury Regarding Section 482 Adjustments and Relief Under Rev. Proc. 64-54*, in INSTITUTE ON U.S. TAXATION OF FOREIGN INCOME, INC., PROCEEDINGS 5, 9 (1965) [hereinafter cited as PROCEEDINGS].

60. 1964-2 CUM. BULL. 1008. See Ruocco, *How to Take Full Advantage of the Relief Available from Section 482 Allocations*, 26 J. TAXATION 360 (1967).

61. Rev. Proc. 64-54, § 3.01, *supra* note 60, at 1009-10. Rev. Proc. 72-22, 1972 INT. REV. BULL. No. 13, at 25, provided that Rev. Proc. 64-54 is available when the United States taxpayer is a controlled foreign corporation.

originally treated the transactions giving rise to the section 482 allocations in a manner consistent with the section 482 allocations.”<sup>62</sup> This would be in excess of the United States tax liability in some cases, but no refund was to be given in such situations.<sup>63</sup>

Section 3.02 of Revenue Procedure 64-54 established several conditions as prerequisites for the offset. The primary condition was a written statement that “economic double taxation” had resulted from the section 482 reallocation. The taxpayer was further required to execute a closing agreement, as part of which he agreed to forego claiming a tax credit for the amount of tax allowed as an offset, and to pay to the United States any recovery of foreign taxes attributable to the section 482 reallocation.<sup>64</sup>

The revenue procedure also provided for what it termed “elimination of undue hardship.”<sup>65</sup> This was simply a statement by the Internal Revenue Service that it would not make section 482 reallocations in the following situations: interest on loans and advances, royalties for the use of intangible assets, and allocation of overhead. The procedure indicated certain exceptions to this abstention by the Service, however. For example, if a controlling United States taxpayer borrowed funds and incurred interest expense in lending the funds to the controlled foreign entity, the special relief would not be available.<sup>66</sup> Relief was also provided when the foreign affiliate, within 60 days after the close of its taxable year, distributed to its shareholders as a dividend 90 percent or more of its earnings for that year.<sup>67</sup> Although a reallocation was not made for the purpose of increasing the United States tax, it could be made, if necessary, for the purpose of computing the allowable foreign tax credit under Internal Revenue Code section 904.

Another problem was the potential tax consequences of the transfer of funds among the various entities to reflect section 482 allocations. Revenue Procedure 65-17 provided the method by which such transfers could be made without further tax consequences.<sup>68</sup> The procedure required the creation of an account receivable equal to the amount of the allocation, less any offset allowed under section 3 of Revenue Procedure 64-54 and any dividend adjustment made for the

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62. Rev. Proc. 64-54, § 3.01, *supra* note 60, at 1008-09.

63. Because of the variety of situations in which the offset could arise, Rev. Proc. 65-31, 1965-2 CUM. BULL. 1024, was issued setting forth the manner of computing it.

64. Rev. Proc. 64-54, § 3.02, *supra* note 60, at 1009-10.

65. Rev. Proc. 64-54, § 4, *supra* note 60, at 1011-12.

66. Rev. Proc. 64-54, § 4.02, *supra* note 60, at 1012.

67. Rev. Proc. 64-54, § 4.02, *supra* note 60, at 1012.

68. 1965-1 CUM. BULL. 833.

year of allocation, plus interest accrued on such account receivable. This account receivable could then be paid within 90 days by a transfer of funds, or by an accounting entry if there were offsetting debts, and to the extent of any balance by an interest-bearing promissory note payable at a fixed date. The interest was required to be such as would be determined in an arm's-length transaction.

Revenue Procedure 65-17 also gave the taxpayer the option of treating any dividends received from a foreign entity that was a party to a section 482 allocation and which it had included in gross income for the year of adjustment as a payment attributable to the allocation. To that extent the taxpayer was permitted to amend the previous return. The amount which under this election was excluded from gross income could not exceed the increase in gross income that resulted from the allocation, less the amount of offset allowed under Revenue Procedure 64-54. Moreover, to the extent that this amount was excluded, it would no longer be treated as a dividend for any federal income tax purpose.

It had been originally determined that the cut-off date under Revenue Procedure 64-54 was to be December 31, 1962. In partial response to criticism that consistency with the Treasury position as to notice required that the relief be extended until issuance of the final regulations,<sup>69</sup> however, the Internal Revenue Service extended the relief. This was done although the Service felt taxpayers had been given notice by the attempted amendment of section 482 in 1961,<sup>70</sup> because there had been substantial delay in issuing the proposed regulations.<sup>71</sup> The relief granted by Revenue Procedure 65-17 was applicable in all cases arising for years prior to January 1, 1965 for which taxable income was increased by the Internal Revenue Service under the authority of section 482.<sup>72</sup> For the years beginning after Decem-

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69. One commentator argued that while taxpayers were alerted to the section 482 problem in 1962 when the Conference Committee on the Revenue Act of 1962 authorized the Commissioner to promulgate regulations, there could be no valid notice as to the character of the section until final regulations were adopted. Kirrane, *Observations on Revenue Procedure 64-54*, 44 TAXES 168, 172-73 (1966).

70. See text accompanying note 13 *supra*.

71. While Revenue Procedure 64-54 was responsive to the criticism that section 482 was being applied to certain transactions in a novel and retroactive manner, it did not immunize all pre-1965 transactions from adjustment. The regulations had always been clear in requiring an arm's length charge for services or merchandise, thus sales and base company operations remained subject to the application of section 482. Remarks by Richard O. Leongard, Jr., Special Assistant for International Tax Affairs, U.S. Treasury Department, March 9, 1965 in *Foreign Income—Section 482 Allocations*, 115 TAX MANAGEMENT PORTFOLIOS, B-45, B-48 (1966).

72. Rev. Proc. 65-17, as amended, Rev. Proc. 65-17 Amendment I, 1966-2 CUM. BULL. 1211.

ber 31, 1964 the relief was only available if the Internal Revenue Service determined the transactions or arrangements upon which the section 482 allocation was based did not have as one of the principal purposes the avoidance of federal income taxes.<sup>73</sup> As would be anticipated, the relief provisions were not available for any period in which tax fraud was involved.

In addition to the reasons already considered, other broad policy considerations suggested the need for unilateral relief from double taxation. The Treasury was attempting to formulate the section 482 guidelines at the same time that a large number of deficiencies based on section 482 reallocations were being proposed. Although an orderly processing of these deficiencies was essential, avoidance of mass resistance to the proposed regulations by the international business community was also important. The Treasury decided that this could best be averted by foregoing nonessential adjustments, and only applying section 482 to the extent of its previously developed guidelines.<sup>74</sup> This approach was successful, and with the cooperation of the business community the deficiencies for the pre-1965 years were disposed of with a minimum of conflict, and the new regulations were developed.<sup>75</sup>

As noted above,<sup>76</sup> this additional unilateral relief was limited in duration. The Treasury's position, as stated by then Assistant Secretary Stanley Surrey, was that "the limitation recognizes that a country cannot continue to administer such section in this self-defeating manner, for the continued allowance of the foreign tax offset would simply mean that the United States would be yielding control over its allocation problems to the allocation rules of foreign countries and the decisions of their administrators."<sup>77</sup> This quotation reflects the attitude of United States tax administrators that other countries must share the obligation of making adjustments to avoid double taxation. There is

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73. Among the factors to be considered by the IRS in making its determination are the following: the amount of dividends received from the corporation which was a party to the transaction giving rise to the allocation; whether there was a good faith effort to comply with the regulations promulgated under section 482; the extent to which the transaction contravened these regulations; and the amount of income taxes (in both countries) which resulted from the transaction. The relative weight of the factors depends on the facts of each case. Rev. Proc. 65-17, § 3.02, *supra* note 68, at 834.

74. Surrey, *The United States Tax System and International Tax Relationships—Current Developments 1965-1966* in TAX INSTITUTE OF AMERICA, SYMPOSIUM, TAXATION OF FOREIGN INCOME 256, 282-83 (1966).

75. Paul D. Seghers, President of the Institute on U.S. Taxation of Foreign Income, Inc., stated in a report dated September 16, 1966, that 70 percent of those members of the Institute replying to a survey favored *all* the proposed regulations. Copy of report bound in Stanford Law Library volume of PROCEEDINGS, *supra* note 59.

76. See text accompanying notes 69-73 *supra*.

77. Surrey, *supra* note 74, at 283.

some indication that other countries agree with this position.<sup>78</sup> At the moment, the competent-authority concept derived from the mutual-agreement clause contained in most bilateral treaties<sup>79</sup> appears to offer the most satisfactory approach.

The United States tax treaties generally have provided authority for the administrative officials of one country to contact their opposite numbers in the other country to develop an equitable solution of a taxpayer's problems.<sup>80</sup> Similar consultative provisions are also frequently found in the grievance procedure articles of treaties.<sup>81</sup> This mutual agreement procedure provides a tool with which the competent authorities of each state can explore the possibility of equitable solutions to problems which the treaties cover only in general terms, while preserving the sovereignty of each country in tax matters.<sup>82</sup>

Most of the United States treaties follow the wording of the OECD draft as to the type of double taxation that will justify the initiation of a claim under the competent-authority provision: "double taxation contrary to the provisions of this Convention."<sup>83</sup> A few treaties use the words "double taxation . . . in respect of any of the taxes to which the present Convention relates."<sup>84</sup> Any apparent distinction in the intended meanings of these two typical provisions may be illusory.<sup>85</sup>

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78. Unpublished remarks of Robert T. Cole, International Tax Counsel, Treasury Department, April 23, 1971, at Boalt Hall School of Law, University of California at Berkeley. See also Cole, *supra* note 17, at J-4, J-5.

79. The convention with Ireland is the only United States tax treaty not containing such a provision.

80. Gordon, *supra* note 53, at 468-69.

81. E.g., Convention with the Commonwealth of Australia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, May 14, 1953, art. xviii, [1953] 2 U.S.T. 2274, T.I.A.S. No. 2880 [hereinafter cited as Australia]; Convention and Protocol with Sweden Respecting Double Taxation, March 23, 1939, art. xx, 54 Stat. 1759, T.S. No. 958 [hereinafter cited as Sweden]. In the O.E.C.D. Draft and in many United States treaties the grievance procedure is incorporated in the mutual agreement article. O.E.C.D. DRAFT, *supra* note 44, art. 25(1); Convention with the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, October 28, 1948, art. 25(1), [1953] 2 U.S.T. 1647, T.I.A.S. No. 2833 [hereinafter cited as Belgium]; Convention with the Republic of Finland with Respect to Taxes on Income and Property, March 6, 1970, art. 28, [1971] 1 U.S.T. 40, T.I.A.S. No. 7042 [hereinafter cited as Finland]; Convention with the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income, July 22, 1954, art. xviii(1), [1954] 2 U.S.T. 2768, T.I.A.S. No. 3133 [hereinafter cited as Germany].

82. Thrower, *supra* note 9, at 483.

83. S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS, IX-300 (1968) [hereinafter cited as ROBERTS & WARREN].

84. *Id.* at IX-301.

85. Roberts and Warren state that the United States takes a position which ignores the difference in terminology. *Id.* at IX-300-02.



There is also some variation in the grievance procedure provisions, some treaties requiring the occurrence of double taxation before it can be invoked,<sup>86</sup> while others allow the taxpayer to present his claim if double taxation is likely to result from the activities of the tax authorities.<sup>87</sup>

An examination of the consultation provisions indicates that even without the broad language found in the Canadian and some other treaties, they generally should be adequate to cover the problems arising from section 482 reallocations. In the past, however, many countries have been unwilling to negotiate claims of double taxation resulting from a reallocation of income on the ground that it was not within the purview of the consultation provision.<sup>88</sup> It should be noted that the commentary on article 25(2) of the OECD Draft makes it clear that it was meant to cover cases of 482 type reallocations.<sup>89</sup>

The new double-taxation treaties which the United States has negotiated contain a broad grant of authority to the competent authority concerning allocations of income and the prevention of double taxation. The competent-authority provision grants specific authority to agree to allocation of income, deductions, credits, or allowances between a resident of one of the contracting states and any related person.<sup>90</sup> Some of the other treaties, such as those with New Zealand, Pakistan and the United Kingdom, contain different language but, in effect, grant the same authority to agree to allocations between an enterprise and its permanent establishment, and among related entities.<sup>91</sup>

Of special interest and importance is the provision, contained in seven of the United States treaties, that authorizes the competent au-

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86. Convention with Canada for the Avoidance of Double Taxation, March 4, 1942, art. xvi, 56 Stat. 1399, T.S. No. 983; Sweden, *supra* note 81, art. xx.

87. E.g., Australia, *supra* note 81, art. xvii; Convention with Austria for the Avoidance of Double Taxation, October 25, 1956, art. xvii, [1957] 2 U.S.T. 1699, T.I.A.S. No. 3923; Belgium, *supra* note 81, art. 25(1); Convention with Japan for the Avoidance of Double Taxation, April 16, 1954, art. xviii, [1955] 1 U.S.T. 149, T.I.A.S. No. 3176.

88. Comment, *The Competent Authority Concept in United States Tax Treaties*, 2 LAW & POL. INT'L BUS. 232, 247 (1970).

89. OECD DRAFT, *supra* note 44, at 155.

90. Belgium, *supra* note 81, art. 25(2); Convention with the French Republic with Respect to Taxes on Income and Property, July 28, 1967, art. 25, [1968] 4 U.S.T. 5280, T.I.A.S. No. 6518 [hereinafter cited as France].

91. Convention with New Zealand Relating to Taxes on Income, March 16, 1948, art. xviii(1), [1951] 2 U.S.T. 2378, T.I.A.S. No. 2360; Convention with the Government of Pakistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, July 1, 1957, art. xvi(2), [1959] 1 U.S.T. 984, T.I.A.S. No. 4232; Convention and Protocol with the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, April 16, 1945, art. xxA(2), 60 Stat. 1377, T.I.A.S. No. 1546 [hereinafter cited as United Kingdom].

thorities, if they reach an agreement on an allocation question, to arrange for the adjustment of income and a refund or credit of taxes.<sup>92</sup> This provision is also contained in two of the new treaties that are not as yet in force.<sup>93</sup> A responsible official of the Internal Revenue Service has stated that the Treasury will seek to include an equivalent provision in any new treaties and in any renegotiation of existing treaties,<sup>94</sup> an indication of the importance of the competent-authority provision as a tool for the settlement of double-taxation problems. The provision has been interpreted to permit the issuance of a refund or credit notwithstanding procedural barriers, as, for example, the running of the statute of limitations.<sup>95</sup>

A further advance in the settlement of double-taxation problems is contained in the equivalent OECD Draft provision. Paragraph 3 of article 25 gives the competent authorities the right to consult together in an effort to eliminate double taxation even in cases that are not covered by the Convention. The commentary on this paragraph gives an example of its application to a resident of a third state with a permanent establishment in each contracting state.<sup>96</sup>

Although prior to 1970 sixteen of the treaties to which the United States is a party specifically gave the Treasury the power to engage with foreign states in negotiations concerning appropriate allocations of income, there was no definite procedure prescribed for presenting a claim to the competent authority.<sup>97</sup> The issuance of Revenue Proce-

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92. Belgium, *supra* note 81, art. 25(4); Finland, *supra* note 81, art. 28(4); France, *supra* note 90, art. 25; Germany, *supra* note 81, art. xvii(3); Convention with the Kingdom of the Netherlands with Respect to Taxes on Income and Certain Other Taxes, April 29, 1948, art. xxiv(2), 62 Stat. 1757, T.I.A.S. No. 1855; Convention with the Government of Trinidad and Tobago for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Encouragement of International Trade and Investment, January 9, 1970, art. 23(2), [1971] 1 U.S.T. 164, T.I.A.S. No. 7047; United Kingdom, *supra* note 91, art. xxA(3) and (4).

93. Convention with the Government of the United States of Brazil for the Avoidance of Double Taxation with Respect to Taxes on Income, March 13, 1967, art. 24(2), CCH TAX TREATIES ¶ 827; Convention with the Government of Israel for the Avoidance of Double Taxation of Income and for the Encouragement of International Trade and Investment, June 29, 1965, art. 24, CCH TAX TREATIES ¶ 4227.

94. Thrower, *supra* note 9, at 483.

95. U.S. Treasury, Technical Explanation by Treasury Department on the Convention Between the United States and Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed July 9, 1970, CCH TAX TREATIES ¶ 596 at 703-27.

96. OECD DRAFT, *supra* note 44, at 156.

97. Comment, *supra* note 88, at 238, 244, 246; Aversa, *International Tax Allocations and Treaty Relief Through Competent Authority Procedures*, 19 THE TAX EXECUTIVE 15, 17 (1966).

dure 70-18 filled this void.<sup>98</sup> It gave taxpayers a definite statement of the procedure for invoking the competent-authority provision of a tax treaty and of the extent to which the competent authority would take action in his behalf. The issuance of the ruling also gave notice of the Treasury's interest in accepting taxpayer claims, and some support to the enunciated statement of the Treasury that in the international business arena its function is to represent "United States taxpayers in their relationships with foreign tax officials."<sup>99</sup>

The Revenue Procedure modifies the location of the competent authority within the Internal Revenue Service. The Assistant Commissioner (Technical) remains the competent authority in matters concerned with interpretation or application of tax treaties, but the Assistant Commissioner (Compliance) replaces the Director of the Office of International Operations in cases involving operating provisions. The change has two effects: It upgrades the competent authority, putting it at a level commensurate with that in most of the countries with which we have treaties; and it assigns the authority to the office that exercises functional control over the operating branch of the Internal Revenue Service. The Assistant Commissioner (Compliance) is the appropriate office of the Internal Revenue Service to exercise this function inasmuch as his office would process the case domestically, and, in the event of a proposed allocation by a foreign country, the United States correlative adjustment would be submitted to Internal Revenue Service officials below the Assistant Commissioner (Compliance).<sup>100</sup>

Revenue Procedure 70-18 sets forth the procedure to be followed in a variety of situations. The Procedure, however, is applicable only to cases involving an adjustment of income tax resulting from a reallocation made between controlled entities under the internal law of one of the contracting states.<sup>101</sup> In the cases the competent authority accepts, he will seek to arrive at an agreement with the treaty partner as to an allocation that reflects an arm's-length standard.<sup>102</sup>

Section 5 of Revenue Procedure 70-18 sets forth the procedure to be followed by the taxpayer if the United States proposes the allocation. Normally, a written request must be filed before the statute of limitations has run in the United States. If the statute of limitations has run but the competent authority agrees to take the case, his activity will be

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98. 1970-2 CUM. BULL. 493.

99. Cole, *supra* note 17. In personal conversation the Assistant Commissioner (Compliance) indicated that there has been a very substantial increase in competent authority references since the issuance of Rev. Proc. 70-18.

100. Cole, *supra* note 17.

101. Rev. Proc. 70-18, § 3.01, 1970-2 CUM. BULL. 494.

102. Rev. Proc. 70-18, § 3.02, 1970-2 CUM. BULL. 494.

limited to assistance in securing the appropriate correlative adjustment in the foreign state. It has been noted previously<sup>103</sup> that several United States treaties contain a provision which, contrary to section 5.09, allows use of the mutual-agreement procedure regardless of procedural barriers. Moreover, section 4.08's similar limitation when the other country proposes the allocation is not applicable when there is such a treaty provision.<sup>104</sup> The claim required by Revenue Procedure 70-18 should be filed after the case is sufficiently developed to warrant consideration by the competent authority, and the taxpayer is still faced with an unsatisfactory settlement of issues.

Among the items of information required by section 5.07 to be included with the request for assistance is a statement of the actions taken by the related foreign entity to secure an appropriate correlative adjustment in its return and any requests for assistance it has directed to the foreign competent authority. The taxpayer is also required to submit a statement describing the extent to which he is willing to be bound by any agreement reached by the competent authorities and his willingness to enter into a closing agreement consistent with such agreement.

The Procedure envisions that a taxpayer will pursue and exhaust his administrative remedies before seeking judicial relief. The Treasury policy is to encourage recourse to the competent authority before the initiation of litigation. In cases that have already proceeded to court, the competent authority will require the consent of the Chief Counsel before accepting the case.<sup>105</sup> If the case is accepted, the competent authority may limit his intervention to the rendering of assistance, rather than utilizing the full scope of his power by seeking a delay in the judicial proceedings. In any case, the final decision on delaying court action rests with the court in which the action was brought.

Section 4 of the Procedure provides for competent-authority relief when a foreign country proposes the adjustment. The taxpayer should file a request for assistance as soon as the facts have sufficiently developed, but in no event later than 90 days after the proposed adjustments are formally communicated to the related person by the concerned state.<sup>106</sup> In addition to the formal request, a claim for any credit or refund that may be attributable to the proposed allocation should be filed. As previously noted,<sup>107</sup> the scope of the competent authority's power depends on whether the year in question is still open,

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103. See notes 92-95 *supra* and accompanying text.

104. Rev. Proc. 70-18, § 4.08, 1970-2 CUM. BULL. 496.

105. Rev. Proc. 70-18, § 5.06, 1970-2 CUM. BULL. 496.

106. Rev. Proc. 70-18, § 4.02, 1970-2 CUM. BULL. 495.

107. See text accompanying notes 103-04 *supra*.

unless there is a treaty provision which has the effect of waiving the statute of limitations. When the statute of limitations is a consideration, the refund or credit claim should be filed before the expiration of the statutory period, stating the amount of information presently known.<sup>108</sup> The Procedure is silent as to the manner of filing for a refund or credit in those cases not subject to the statute of limitations because of the treaty provisions. Presumably the claim should be filed with an adequate statement as to the circumstances, including reference to the appropriate treaty provisions. The Revenue Procedure is quite explicit in stating that the claim or refund will be allowed only to the extent determined by the mutual agreement or as otherwise determined by the competent authority.<sup>109</sup> Section 4.06 states that the decision of the United State's competent authority shall be final and not subject to judicial review.

Among the remaining matters provided for in the Procedure, section 6 states that related entities should be advised to take the necessary action with the foreign taxing authorities. Section 8 states the relationship of competent-authority relief provided by Revenue Procedure 65-17.<sup>110</sup> Since the relief provided by Revenue Procedure 65-17 must be requested in writing prior to the closing of action on the 482 issue, the relief must be requested prior to a closing agreement entered into with the competent authority under section 4.03 of Revenue Procedure 65-31.<sup>111</sup> Section 9 gives the competent authority discretion in accepting requests for relief. The competent authority will only retain the case if the taxpayer is cooperative. A taxpayer can appeal a refusal of assistance to a panel appointed by the Commissioner, but the decision of the panel is final.

There remains the question of when a case is sufficiently developed to justify implementing the competent-authority provisions. One situation that meets the requirement is when the taxpayer and the Service have agreed upon the amount of the adjustment, contingent on the taxpayer's obtaining a correlative adjustment in the other concerned state. Second, if there is a failure to agree and the taxpayer files a protest and has made a reasonable attempt to reach a settlement at the appellate division conference, the case is probably sufficiently mature for competent-authority consideration as well.<sup>112</sup> Some thought has been given to amending Revenue Procedure 70-18 to require that all unagreed cases go to the appellate level before competent-

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108. Rev. Proc. 70-18, § 4.05, 1970-2 CUM. BULL. 495.

109. Rev. Proc. 70-18, § 4.06, 1970-2 CUM. BULL. 495-96.

110. 1965-1 CUM. BULL. 833.

111. 1965-2 CUM. BULL. 1036.

112. Cole, *supra* note 17.

authority relief is available,<sup>113</sup> but no action in this regard has as yet been taken.

### III

#### ALTERNATIVE MEANS FOR AVOIDING DOUBLE TAXATION

Although the competent-authority procedure does afford some relief in double-taxation situations, it is certainly not a complete solution. Relief is available only when the problem of double taxation arises among entities in countries having a treaty providing for mutual agreement. Even when treaty countries are concerned, the variation in the powers given to the competent authorities may make the solution of the problem difficult to achieve. A first step in making the competent-authority procedure more useful would be to standardize the provisions in all double-taxation treaties. Either through renegotiation of the treaty provisions or by mutual agreement, the competent authority should be given the power to relieve double taxation without regard to procedural barriers. Some means should also be devised to make the competent-authority procedure available even if the two concerned countries do not have an income tax treaty. Presently in such situations the cumbersome use of diplomatic channels is usually required.

Another defect is the discretion given to the competent authority to accept or reject a case. In the United States there has been some attempt to restrict this arbitrary authority by providing in Revenue Procedure 70-18 that rejection may be overruled by a review panel. The procedure does not prescribe the composition of the panel, however, nor are there any appeal guidelines for the interested parties. Specific guidelines should be provided, such as those in Revenue Procedure 65-17, for determining whether relief should be available in post-December 31, 1964 cases.<sup>114</sup> There also should be a right of appeal to judicial authorities on the sole issue of whether or not tax avoidance was a principal motive behind the transaction giving rise to the allocation.

One clear weakness in any procedure that would force the competent authority to accept a case he had previously rejected is the lack of compulsion on him to reach a satisfactory accord with his counterpart. The treaties generally imply a duty to attempt to reach an agreement, but there is no means of recourse if the competent authorities do not agree. Although the competent authority, as indicated in Revenue

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113. *Id.*

114. Rev. Proc. 65-17, § 3, 1965-1 CUM. BULL. 834, as amended, Rev. Proc. 65-17, Amendment I, 1966-2 CUM. BULL. 1211.

Procedure 70-18, can take unilateral action without consultation with his counterpart, this is only of assistance to the taxpayer when the country taking the action has initiated the proposal. Further, in the United States procedure, such unilateral actions are limited to those situations where the Assistant Commissioner (Compliance) finds the United States position unreasonable.

It is essential that the competent-authority function in the area of allocations be improved. This can be done in various ways. One would be to provide for rules of allocation in a protocol to the treaty.<sup>115</sup> This probably would not be as flexible as if guidelines were set forth in regulations promulgated under the treaty. The difficulty with such guidelines, however, is the lack of uniformity that results if each of the treaty countries would be free to promulgate guidelines under its own interpretation of the treaty provision. This lack of uniformity would be a substantial drawback to the orderly regulation of international transactions.

Another possible solution would be a multilateral double income tax convention containing a specific set of international rules of allocation.<sup>116</sup> Professor Surrey suggested a similar uniform allocation provision for United States treaties.<sup>117</sup> If a single master treaty were promulgated, it would be an effective vehicle to house the allocation guidelines. If it was not considered appropriate to have detailed guidelines in a treaty, the problem could be handled by providing for guidelines to be promulgated by the OECD or some similar body with changes or variations to be made only by agreement of the concerned fiscal authorities. This would allow for flexibility without the necessity of engaging in the cumbersome procedures required for treaties. The OECD has recognized that something of this character is needed in order to obtain a wider measure of agreement on the rules for allocating or re-allocating income to a permanent establishment or among related enterprises.<sup>118</sup>

Another possible improvement would be to provide an adequate remedy when the competent authorities are unable to agree as to the proper allocation. A method for achieving this improvement was suggested as early as the 1928 Draft Convention.<sup>119</sup> Subsequently, the International Chamber of Commerce suggested that a provision be incorporated referring unsolved disputes to a conciliation commission or

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115. See Gordon, *The Role of Tax Treaties*, 43 TAXES 463, 469 (1965).

116. See, e.g., OECD DRAFT, *supra* note 44.

117. Surrey, *The United States Tax System and International Tax Relationships*, 43 TAXES 6, 14 (1965).

118. OECD DRAFT, *supra* note 44, ¶ 54 at 27.

119. See text accompanying note 42 *supra*,

to an arbitrator.<sup>120</sup> The conciliation commission could be composed of representatives of the competent authorities or of independent international tax experts. Under the ICC proposal direct recourse to the conciliation commission would be available to the taxpayer if he claimed to have been taxed contrary to the provisions of the treaty. This latter remedy is of importance only if the competent authority has discretionary power to accept or reject cases. The conciliation commission should be available in all instances when the taxpayer has been the subject of double taxation and the competent authorities have failed to reach an agreement. It also should be available when the taxpayer contends the competent authorities did not make diligent effort to eliminate the double taxation. If granting this jurisdiction caused an overwhelming flood of matters to be brought before the commission, a hearing officer system could be devised to screen the appellants.

A variation of this suggestion is to create an International Tax Court along the pattern of the World Court which would have jurisdiction to determine disputes of taxpayers who allegedly had been subjected, or were threatened with being subjected, to double taxation involving more than a single country. This suggestion has received very little support from tax authorities and the difficulty of constituting such a court makes adoption improbable.

A suggestion was made in the comments to article 25 of the OECD Draft Convention that the OECD render opinions as to the interpretations of treaty provisions.<sup>121</sup> The comment argued that such a role for the OECD would "make a valuable contribution to arriving at a desirable uniformity in the application of the provisions."<sup>122</sup> In order to implement such a procedure, there would have to be agreement on international rules of allocation. If such an agreement is achieved, it will be in large part through the efforts of the OECD Fiscal Committee, which would then be in an ideal position to render interpretive opinions relating to such rules.

There are few options other than those considered heretofore for the avoidance of double taxation caused by reallocations. Unilateral relief is, of course, an easy answer; but most countries believe, as does the United States, that they should not bear the burden of double taxation alone.

One commentator has suggested a sort of international "hotch pot," with each country throwing in the double-taxation claims of its tax-

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120. COMMISSION ON TAXATION, INTERNATIONAL CHAMBER OF COMMERCE, DOUBLE TAXATION: SETTLEMENT OF DISPUTES 4 (1959).

121. OECD DRAFT, *supra* note 44, at 156.

122. *Id.*



payers and then settling by trading their claims off against the claims of other countries.<sup>123</sup> He argues that double taxation should be considered to be a problem of countries, not taxpayers, and that if the basic burden was put on the government a more zealous advocacy would result. In the long run we would achieve greater uniformity in allocation rules. This writer does not consider this "hotch pot" a workable solution, however. It ignores the nature of the taxpayer's activity and the extent to which his own dealings have caused or aggravated the double taxation. It is doubtful if such a proposal would do much to bring about international rules of allocation or really alleviate the difficulties engendered by the enforcement of allocation rules by an individual country.

### CONCLUSION

There is general unanimity on the proposition that double taxation should be prevented if possible. One cause of double taxation is the reallocation of the income and expenses of related corporations by the country in which one is located without a correlative adjustment in the other country.

The competent-authority procedure has received the most support of any suggestion for meeting the problem. Its success depends on the diligent effort of the competent authorities in meeting the problem and in exercising reasonableness in their conferences. In order to reach the ultimate objective, uniformity of operation through the medium of binational or multinational treaties, or by consistent internal procedures, is essential.

A determined effort should be made to gain agreement by all nations to a uniform system of rules of allocation. Furthermore, we will need to have agreements on methods for enforcement of the rules. There should also be an international body given the power to make final determinations when the competent authorities are unable to agree. When all this is accomplished, we will have taken giant steps toward prevention of double taxation. In the meantime, the procedure which the United States has established for invoking competent-authority relief is a basis for further improvement.

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123. Roberts, *Avoiding Double Taxation—A Reorientation of the Role of Tax Treaties*, 18 THE TAX EXECUTIVE 7, 10 (1965).