U.S. Taxation of Export Operations: A Primer

William C. Gifford

Follow this and additional works at: https://digitalcommons.du.edu/djilp

Recommended Citation

This Article is brought to you for free and open access by the University of Denver Sturm College of Law at Digital Commons @ DU. It has been accepted for inclusion in Denver Journal of International Law & Policy by an authorized editor of Digital Commons @ DU. For more information, please contact jennifer.cox@du.edu, dig-commons@du.edu.
U.S. TAXATION OF EXPORT OPERATIONS: A PRIMER

WILLIAM C. GIFFORD*

Exports play an increasingly important role in the economic welfare of the United States, as petroleum imports rise, inflation continues, and the dollar declines in value vis-a-vis foreign currencies. The impact of the U.S. tax system on exports would appear to be very significant, to the point of shaping the corporate structures employed by most U.S. exporters. This article will survey the aspects of present U.S. income tax law affecting U.S. export operations, and will focus on the tax considerations which arise at each stage in the life cycle of each of the alternative forms for export operations. Thus, the article will consider exporting through a branch of a domestic corporation, a Western Hemisphere Trade Corporation, a “possessions corporation,” a Domestic International Sales Corporation, and a controlled foreign corporation. The article will examine the tax incidents of formation of each of these vehicles for exporting, the operation thereof (including transfer pricing), and the repatriation of export profits.

To give this survey some focus, the article will look at present law from the point of view of a hypothetical but typical domestic corporation. We shall suppose that the corporation has been highly successful in manufacturing and marketing a high-technology product in the United States market, but previously has made only a few casual sales in foreign markets. Domestically X Corporation, our hypothetical company, might have sold primarily through unrelated jobbers who performed the marketing function with respect to sales to all but X’s largest customers. The jobbers’ commissions averaged about 10 percent of sales. Gradually, the jobbers have been replaced by a staff of salesmen working directly with X, who are compensated on a commission basis at an average rate of about 7 percent of sales. The average U.S. price for X’s product has been $1.00 per unit, but X now expects to be able to sell a substantial volume to the European market at an average price of $1.25 per unit. The standard cost (cost at which the units are carried in X’s inventory) averages about $.60. A prorated share of R & D and general and administrative expenses would bring the full cost per unit to about $.73. No plant expansion will be necessary for X to handle the anticipated increased volume of sales to foreign markets, although X is prepared to expand and/or reorganize its order processing and supporting functions to the extent necessary to handle this export business. Having decided to pursue

* Copyright © 1975 by William C. Gifford, Associate Professor, Cornell Law School; A.B. Dartmouth College; LL.B. Harvard Law School.
the business of exporting its products, the board of directors of X might well analyze the relative desirability of each of the following alternative vehicles for its export business: (1) a branch or a domestic subsidiary of X; (2) a Western Hemisphere Trade Corporation; (3) a "possessions corporation"; (4) a Domestic International Sales Corporation; (5) a controlled foreign corporation.

I. BRANCH OF A DOMESTIC CORPORATION

A. Definition

The term "branch" in this context has no particular technical meaning in the tax law, but generally refers to operations conducted by employees or other agents of a corporation outside the country of incorporation. An office, warehouse, or other supporting facilities may or may not be involved, although the term does suggest some type of permanent location.

B. Tax Effects

The U.S. tax consequences of the formation and operation of a branch are straightforward. Since the branch is not a separate "person," the branch income is subject to the regular U.S. corporate tax rate under § 11 of the Internal Revenue Code. Thus, the United States will tax branch profits at the rate of 22 percent on the first $25,000 of taxable income of the corporation from all sources, and 48 percent thereafter. Losses of the branch will be directly deductible from any U.S. or other income of X Corporation. Any profits earned abroad by a foreign branch may be repatriated to the domestic offices of the parent company without further U.S. tax consequences. In short, foreign branch status is irrelevant to the U.S. taxation of a domestic corporation—the corporation is simply taxed on its worldwide income.

C. Practical Uses

As to whether a foreign branch would be desirable for the conduct of X Corporation's export operations, X will have doubts from the tax point of view. If X expects losses, perhaps start-up losses in its first months or years of exporting, it might consider a branch operation in order to deduct the losses against other income of the corporation. Losses attributable to depreciation and depletion deductions apparently do make the branch form attractive to the U.S. corporations engaged in petroleum and other extractive industries abroad. In other words, the principal tax factor making the branch form desirable is the ability to use foreign losses to offset other income.

1. For 1975 only, Public Law 94-12 reduces the corporate tax rate to 20 percent on the first $25,000 of taxable income, 22 percent on the next $25,000, and imposes the regular 48 percent rate on the balance. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended.
TAXATION OF EXPORT OPERATIONS

of a corporation, but this does not appear to be part of X's situation.

In passing, several non-tax factors affecting the choice of the branch form might be noted. In the first place, determination of the income attributable to a branch by the foreign jurisdiction where the branch is located may present problems. For example, the foreign country might demand extensive data with respect to operating results for all of X Corporation, in order to determine the income taxable to a branch which constituted a "permanent establishment" under an applicable U.S. income tax treaty, or the amount of income taxable under provisions of foreign laws analogous to the "effectively connected" provisions of §§ 881-82. More generally, a branch in a foreign country may subject all the assets of the domestic corporation to the jurisdiction of foreign courts. It should be noted in this connection that the United States itself has been quite aggressive in asserting jurisdiction across national boundaries. United States v. First National City Bank\(^2\) shows how far U.S. courts have gone in asserting this jurisdiction. In that case, the Supreme Court upheld a district court injunction freezing the account of a foreign corporation in the Montevideo branch of First National City Bank, pending resolution of certain U.S. tax claims against the corporation. The Application of Chase Manhattan Bank\(^3\) shows that there are some limits to this process, however. Chase holds that the United States courts will not compel a domestic corporation to take illegal action abroad, in that case to comply with a grand jury's subpoena of records of the bank's Panama branch. These cases demonstrate an analogy for present purposes—most foreign countries do or can go just as far as the United States in asserting jurisdiction. This situation may go far to explain the writer's experience in practice, to the effect that general counsel for a U.S. industrial corporation seldom if ever let their corporation have a foreign branch. Counsel avoid "doing business abroad" at almost all costs.

One question which naturally follows is what to do then, if a foreign branch should be desirable from the U.S. tax point of view. The obvious solution would seem to be to use a domestic subsidiary to conduct a branch operation. The U.S. parent corporation could file a consolidated U.S. income tax return with the subsidiary and get about the same U.S. tax results as if the corporation itself had formed a branch. In a consolidated return, the incomes of the parent corporation and the 80 percent owned domestic subsidiaries are, in effect, aggregated and the group treated somewhat like a single taxpayer.

Concerning consolidated returns, one special alternative type of

\(^3\) 297 F.2d 611 (2d Cir. 1962).
branch in the consolidated return context should be noted. Under § 1504(d), 100 percent-owned Canadian or Mexican subsidiaries of a domestic parent corporation can join in a consolidated return, where the subsidiaries are maintained as foreign corporations "solely for the purpose of complying with" Canadian or Mexican laws as to "title and operation of property." Revenue Ruling 71-523 shows that the Internal Revenue Service construes § 1504(d) rather narrowly. The Revenue Ruling holds that a corporation organized in Canada in order to qualify for a government grant relating to the development of new and improved products for Canadian markets, including the acquisition of technical data, inventions, methods and processes from the development process, does not meet the statutory test.

II. WESTERN HEMISPHERE TRADE CORPORATIONS

A. Tax Effects

A Western Hemisphere Trade Corporation's (WHTC) principal U.S. tax attraction is that the corporation is entitled to a special deduction, under § 922, in an amount equal to 14/48 of the corporation's taxable income. This special deduction thus lowers the maximum effective U.S. tax rate on the earnings of the corporation to 34 percent:

\[
\begin{array}{l}
\text{Taxable Income Before Section 922 Deduction} & \text{\$100.00} \\
\text{Section 922 Deduction (14/48 x \$100)} & -29.17 \\
\text{Taxable Income} & 70.83 \\
\text{U.S. Tax at 48\%} & 34.00
\end{array}
\]

In addition, because a WHTC is a domestic corporation and eligible to join with related corporations in filing a consolidated income tax return, it is possible for a WHTC to have any operating losses realized by the corporation offset profits of its consolidated group. The consolidated return alternative available for a WHTC has the further advantage of making it possible to repatriate the earnings of the corporation without further U.S. tax under Treasury Regulation § 1.1502-14(a), which excludes intercorporate dividends from gross income in the consolidated return context. In any case, dividends from a WHTC would be eligible for the dividends-received deduction of 85 percent of the amount of the dividends itself, under § 243, so that the maximum effective U.S. tax rate on such dividends would be 7.2 percent. A corporate shareholder which controlled 80 percent or more of the stock of a WHTC might also repatriate the WHTC's earnings in a liquidation tax-free under § 332.

B. Definition

The principal definitional requirements for a WHTC are four in

number: (1) a domestic corporation; (2) all of whose business (other than incidental purchases) is done in countries of North, Central or South America or the West Indies; (3) 95 percent of whose gross income is derived from sources without the United States; (4) 90 percent of whose gross income is derived from the active conduct of a trade or business.

1. Domestic Corporation

Our hypothetical client, X Corporation, can easily meet the requirement that a WHTC must be a "domestic" corporation. Section 7701(a)(4) says that the term "domestic" in this context means "created or organized in the United States or under the law of the United States or of any State" while the apparent distinction in the statute between corporations "organized in" as compared with "under the law of" the United States or the states is an interesting one, the disjunctive structure of the definition makes clear that our client can simply form a corporation under the law of any state, such as Delaware, and meet the "domestic" requirement. Incidentally, the domestic status of the corporation makes it possible to organize the corporation tax-free under § 351 or liquidate it under § 332 without the requirement of an advance ruling under § 367.

2. Western Hemisphere Business

The requirement that all business other than incidental purchases be done in Western Hemisphere countries (including the United States) may or may not prove to be a problem for our hypothetical client. Treasury Regulation § 1.921-1 takes the position that "incidental" means "minor" in relation to the entire business of the operation or "non-recurring or unusual in character," and goes on to provide a safe haven for any corporation whose aggregate purchases do not exceed 5 percent of the corporation's gross receipts from all sources for the taxable year. The case law, notably Topps of Canada, Ltd.,7 upholds the validity of this definition and specifically rejects the argument that "incidental" refers to purchases "incident to" the corporation's business. In the Topps case, purchases of merchandise outside the Western Hemisphere in excess of 34 percent of the corporation's gross receipts were held not to be "incidental." On the other hand, the Court of Claims approved purchases of components manufactured in Europe which represented as much as 16.9 percent of the corporation's gross receipts in Otis Elevator Co. v. United States.8 Neither the statute nor the regulations give any guidance as to the standards for determining where purchases occur. In Topps the Tax

Court apparently assumed that the place of purchase is where title to the buyer passes, since the suspect purchases in that case involved goods originating in Hong Kong, which were sold f.o.b. Hong Kong and c.&f. New York. A cautious taxpayer, however, might not be willing to rely on mere title passage instead of a source test, for determination of the place of purchase, in the absence of further authority on this point.

Looking down the distribution chain envisioned for our hypothetical export operation, instead of up the production chain to the source of purchases, we encounter a further problem with the requirement that all business must be done in Western Hemisphere countries. A WHTC cannot have salesmen plying the European continent or other markets outside the Western Hemisphere. Perhaps the marketing job can be performed by unrelated distributors or commission agents whose activity will not be ascribed to the WHTC. Treasury Regulation § 1.921.110 does make clear that mere retention of title to goods sold in England until the acceptance of the bill of lading and draft solely in order to insure collection, will not cause a corporation to be considered as carrying on business outside the Western Hemisphere. This section of the regulations, thus, seems to approve limited “incidental” economic contact outside the Western Hemisphere, even where “purchases” are not involved.

3. Income From Sources Without the United States

A WHTC engaged in export operations can meet the requirement that 95 percent or more of its gross income be derived from sources without the United States easily if the WHTC has reasonable latitude in formulating the terms of its contracts of sale. This is so because the rules of the Code governing the geographical source of income derived from the purchase and sale of personal property are both relatively straightforward and relatively easy to manipulate in order to produce foreign source income. In effect, §§ 861(a)(6) and 862(a)(6) provide that the source of income derived from the purchase and sale of personal property is the place where the sale is made. The cases hold that a “sale without the United States” is one in which title to the property passes outside the United States. This in turn is not controlled merely by the terms of sale, such as f.o.b., f.a.s., c.i.f., or c.&f., but by any explicit provision of the underlying contract of sale as to where title shall pass and by the intention of the parties. The price terms may, however, raise a presumption as to where title was intended to pass in the absence of an explicit provision in the contract of sale.

Treasury Regulation § 1.861-7(c) provides that, “where bare

10. Supra note 7.
legal title is retained by the seller, the sale will be deemed to have occurred at the time and place of passage to the buyer of beneficial ownership and the risk of loss. This section of the regulations further provides that, in any case in which the sale transaction is arranged for the primary purpose of tax avoidance, mere title passage will not control, but "all factors of the transaction, such as negotiations, the execution of the agreement, the location of the property, and the place of payment will be considered" in determining where the substance of the sale occurred. Nevertheless, *A. P. Green Export Co. v. United States* held that certain sales generated foreign source income where the terms were "f.o.b. factory" in the United States and shipment was by public carrier under a straight bill of lading with the buyer named as consignee, because the contract provided title would pass outside the United States. Recently, the Internal Revenue Service announced that it would follow the holding in this case. It should be noted that § 2-401 of the Uniform Commercial Code seems to leave parties to a sale completely free to agree on when and where title to goods shall pass. Rather than rely on mere title passage, however, careful lawyers will certainly wish to determine a business purpose for a WHTC's retention of title until delivery of the goods at foreign destinations, for example, control of the goods to secure payment of the price and availability of U.S. insurance in the transit period. Furthermore, a WHTC may be well advised to make all of its contracts in the form of "offers" which are accepted abroad by the customer. At the very least, in the absence of a strong trade practice to the contrary, the WHTC will want to specify in the contract explicitly that title passes abroad and use f.o.b. or f.a.s. foreign port terms. Our hypothetical exporter, X Corporation, can easily take these precautions.

4. Active Conduct of Business

The requirement that 90 percent of the corporation's income be derived from the active conduct of a trade or business is intended to preclude use of WHTC's to shelter substantial amounts of investment income. The amount of business "activity" required by the WHTC itself, however, is minimal. In *Frank v. Int'l Canadian Corp.*, the Court held that the taxpayer met the active business requirement even though it had no source of supply, customers, plant, or employee organization. Instead, the taxpayer simply employed a single person

---

12. Id.
16. 308 F.2d 520 (9th Cir. 1962).
who kept its books and reviewed all paperwork, prepared export declarations and custom papers, handled correspondence, and coordinated instructions received from the buyer and supplier of its products. In addition, the taxpayer paid a management fee of $100 to $200 per month for the assistance and facilities provided by its parent company, including opening mail, typing orders and processing invoices, and owning shipping containers. There is a lower limit to how minimal the activity of a WHTC can be, however. In United States Gypsum Co. v. United States,17 the Court found there was no active business where the taxpayer corporation performed no services, resolved no problems, incurred no freight charges, and engaged in no "genuine business activities." The U.S. Gypsum case, however, presents an extreme example. Gypsum rock was mined by a Canadian subsidiary of a U.S. parent corporation and was brought by the subsidiary to a loading dock for shipment. As the gypsum rock crossed the dock, the subsidiary attempting to qualify as a WHTC took title to the rock and owned it only momentarily, while the rock fell from a conveyor on the dock into the hold of an ore-carrying vessel owned by the U.S. parent company. The Court held that this momentary ownership of rock was insufficient to constitute the conduct of an active trade or business, in large part because the taxpayer company's purchase of goods did not involve any concomitant risk of resale.

Distinguishing the U.S. Gypsum situation from the proposed exports to Europe by an export subsidiary of X Corporation would not seem to be difficult at all. Certainly the subsidiary could be given the risk of resale of the goods it purchases, and the subsidiary could have contracts with its parent company for the performance of any services necessary for the various marketing functions, including order processing. The most serious question would seem to arise with respect to our objective of selling in Europe. That is, would retention of title to the goods until they reach their European destination be ruled out by the requirement that all the corporation's business be done in Western Hemisphere countries? As noted above, the regulations make clear that shipping of goods outside the Western Hemisphere and retaining title in order to insure collection of the selling price is not considered as carrying on business outside the Western Hemisphere, and this was recognized in the legislative history.18 Bearing the risks of resale and loss during shipment might make it possible for our proposed WHTC to qualify as such, provided it arranged for the performance of substantial business activities by its own employ-

17. 304 F. Supp. 627 (N.D. Ill. 1969), aff'd, 452 F.2d 445 (7th Cir. 1971).
ees or by the parent corporation.

III. "Possessions Corporation"

A. Tax Effects

Section 931 provides that the gross income of a qualifying "possessions corporation" includes only income from U.S. sources and amounts received in the United States. Section 1504(b)(4) excludes a possessions corporation from the corporations eligible to join in filing a consolidated return, however, and §§ 243-46 exclude dividends from a possessions corporation from eligibility for the dividends-received deduction, so that earnings of a possessions corporation are fully taxable when they are repatriated as dividends. If a possessions corporation is 80 percent or more owned by a corporation, however, the accumulated earnings of the possessions corporation may be repatriated in a tax-free liquidation. Section 367 also presents no problem at the organizational stage because the corporation must be a domestic corporation, and § 351 permits a tax-free incorporation transaction.

B. Definition

In addition to the requirement that the possessions corporation be domestic, the corporation must meet two definitional tests reminiscent of the WHTC tests. First, more than 80 percent of the gross income must be derived from sources within Puerto Rico or U.S. possessions such as the Canal Zone, Guam, American Samoa, and Wake and Midway Islands. Second, more than 50 percent of the gross income of the corporation must be derived from the active conduct of a trade or business in one or more of the possessions.

C. Practical Uses

The definitional requirements probably make possessions corporations unattractive as a vehicle for export operations, apart from exports to the possessions themselves. For example, although it might theoretically be possible to write contracts for the sale of goods to Europe so that title would pass in Puerto Rico, such an arrangement would seem highly artificial and unrealistic, whether or not the goods ever arrived in Puerto Rico itself. A practical limitation is that a possessions corporation might not be able to have salespersons plying the European marketplace, although § 931 does not contain an explicit requirement that all the corporation's business be done in any geographic location, as is the case for a WHTC. The statute does require that 50 percent of the corporation's gross income derive from the active conduct of business in Puerto Rico or the possessions, and it is not clear how this percentage is measured.

One further limitation on the use of a possessions corporation for
exports is that Puerto Rico and the possessions generally impose very substantial income taxes of their own. Their tax exemptions are generally available only for local manufacturing and other specified activities. Accordingly, while possessions corporations are most useful and commonly used where the possession gives the corporation a tax exemption for seven years or more, a possessions corporation would not seem to be a suitable vehicle for the European exports of our hypothetical client, X Corporation.

IV. DOMESTIC INTERNATIONAL SALES CORPORATION

A. Tax Effects

A Domestic International Sales Corporation “DISC” is not subject to the corporate income tax. Instead, its shareholders are treated as having received a dividend each year in an amount equal to about one-half of the taxable income of the DISC for the year. The tax on the remaining earnings of the DISC is deferred until those earnings are actually distributed or the DISC is sold in a taxable transaction. The earnings of the DISC are thus taxed currently at the rate of only 24 percent, and the deferral of tax on the remaining earnings may amount to a substantial advantage.

B. Definition

Section 992 imposes several definitional requirements for a domestic corporation to qualify as a DISC. Ninety-five percent or more of the adjusted basis of the assets of the corporation must be qualified export assets. Qualified export assets are defined to include export property (property produced for export in the United States), assets used in connection with the sale, storage, handling, transportation, packaging or assembly of export property, indebtedness arising by reason of sales of export property, reasonable working capital, producer’s loans, stock or securities of certain foreign selling subsidiaries, certain United States agency obligations, and certain temporary deposits.

The second definitional requirement is that ninety-five percent or more of the gross receipts must consist of qualified export receipts, which in turn include receipts from the sale of export property, interest on qualified export assets, dividends (including amounts included in gross income under Subpart F), and certain other receipts not germane to the export plans of our hypothetical client. The statute specifically excludes receipts from the sale of property which will ultimately be used in the United States, which is subsidized by the United States, which is required to be purchased from the United States pursuant to the “Buy American” programs, which is a natural

19. For a related article, see Comment, infra.
resource or energy product or which has been designated by the President as property in short supply.

The statute further requires that the corporation may not have more than one class of stock outstanding and that the par or stated value of the outstanding stock must be at least $2,500 on each day of the taxable year. Finally, the statute requires the corporation to make an election to be treated as a DISC.

Early on, the Treasury confirmed the legislative intention that a DISC need not have the amount of corporate "substance" normally required for recognition of a corporation as a separate entity for tax purposes. Revenue Ruling 72-166 holds that, in addition to meeting the statutory requirements noted above, a DISC need only have its own bank account, separate books and records, and a sales franchise agreement with any related exporter. The ruling specifically holds that the DISC need have no employees and that a parent manufacturing corporation might solicit orders in its own name and merely pay the DISC a commission on all qualifying export sales. In short, a DISC may do nothing beyond the initial organizational paperwork for its shareholders to reap substantial benefits. While the novelty and complexity of the DISC legislation may have made its reception a little slow at first, it is now clear that the DISC legislation offers an export subsidy several times greater than anticipated by the Congress. The Treasury-OMB tax expenditure budget puts the tax cost of the DISC provisions at $1,070 million for fiscal 1975 and $1,320 million for fiscal 1976.

C. Practical Uses

How should our hypothetical exporter, X Corporation, take advantage of the DISC provision? In light of the above discussion, the simplest approach and probably the one most suited for a small manufacturing corporation like X would be to set up a wholly-owned DISC subsidiary to be compensated on all qualifying export sales on a commission basis, as illustrated in Example (2) of Rev. Rule 72-166. Though commission income is not in itself listed among the qualified export receipts, § 993(f) treats a commission DISC as having received the gross receipts of the parent company on the underlying export transactions. If our DISC performs for a commission, its principal asset at any time will probably be a "commission receivable" from the parent company, a qualified export asset because it is an indebtedness arising by reason of sales of export property. Since the principal income of our commission DISC will be the commissions, the real key to analyzing the benefits held out by the

21. Id.
DISC legislation in our situation is to determine how large the commissions may be. Here there is a further relaxation of the traditional rules regarding the amount of corporate activity required for an entity to earn income. Section 994 provides artificial inter-company pricing rules which complement § 482 and supersede it to the extent that they entitle the DISC to earn an income greater than the § 482 rules would permit.

D. Special Transfer Pricing Rules

The special § 994 rules permit the DISC to be given commissions which will produce a taxable income equal to the greater of 4 percent of the gross receipts on the underlying export sales or 50 percent of the combined taxable income of the parent manufacturing company and the DISC on those sales. The DISC may receive additional taxable income in either case in an amount equal to 10 percent of any "export promotion expenses" incurred by the DISC, although it is unlikely that our proposed DISC will incur any expenses of its own. Two important refinements of the § 994 rules are, first, that the parent manufacturing company may not realize a loss on sales under the 4 percent rule, although the DISC may be reimbursed for any losses which it may otherwise suffer under these pricing rules. Second, the pricing rules apply product-by-product. Thus if our exporting company had some high-profit items and some low-profit items, we could apply the 4 percent rule to the low-profit items, the 50-50 rule of the high-profit items, and leave any losers out completely.

A comparison of the tax costs of exporting directly as compared with exporting through a mere commission DISC will illustrate the operation and benefits of the § 994 pricing rules. Assume for now that our hypothetical exporting company has an unrelated jobber perform the actual marketing function in Europe for a commission of $.15 per unit. Sales by the manufacturing company directly to the European market will therefore produce taxable income of $.37 per unit, on the basis of a $1.25 selling price minus $.60 cost of goods sold minus $.13 share of overhead minus $.15 jobber's commission. By simply forming a paper DISC and paying it a commission for each such export transaction, the manufacturing parent company could reduce its current taxable income on each sale to $.2775, since a DISC which incurred no expenses of its own could be paid a commission of $.185 per unit by the parent company under the 50-50 pricing rule. Only one half of the DISC's commission, or $.0925 per unit, would be currently taxable back to the shareholder of the DISC as a deemed dividend. The remaining $.0925 would not be taxed until the DISC distributed this amount or it was sold or disposed of in a taxable transaction.
E. Uses for DISC Profits

But what must our DISC do with its commission income? The proposed regulations make clear that the commission receivable from the parent manufacturing company cannot be allowed to increase forever, without payment. The commission receivable arising each year must be paid within eight-and-one-half months after the end of the taxable year of the DISC. Accordingly, our hypothetical commission DISC will soon have cash on its hands in an amount that clearly exceeds the working capital reasonably needed by a corporation which has no employees and incurs no other expenses. The DISC may distribute the one half of its income which has already been taxed to its shareholder currently without further tax consequences. Thus, the cash which the DISC must invest in a qualified manner will be limited to the remaining one half of the DISC income. The principal type of investment for such earnings contemplated by the statute seems to be "producer's loans." The rules regarding both the duration and amount of these loans, however, are so restrictive and complicated as to have made producer's loans unattractive, if feasible at all, for most DISC's. Producer's loans are limited to a five-year term. Other principal limitations are that they may not exceed the borrower's export-related assets and the borrower's increase in investment in such assets for the year of the loan. Certain increases in foreign assets and investments may further restrict the benefits of the producer's loan.

Accordingly, some DISCs have turned to investment in obligations issued or guaranteed by the Export-Import Bank or the Foreign Credit Insurance Association. One objection to such investments, in addition to the somewhat unpredictable nature of their availability is that they represent relatively passive uses for DISC funds which might be used advantageously by the parent company itself. An alternative use for the funds which accomplishes this latter objective is for the DISC to purchase from its parent company the accounts receivable which arise on the export transactions in which the DISC participates as a commission agent. The Treasury's DISC handbook and the proposed regulations both approve this form of investment.

Purchases of receivables can be particularly attractive. The Internal Revenue Service has ruled privately that interest on such receivables (or discount in the case of receivables purchased at a discount) constitutes a qualified export receipt and will increase the taxable income of the DISC and the parent company's corresponding interest deduction, with the net result an increase in the amount of taxable income sheltered by the DISC rules.

While the mechanics of purchases and collections of a large vol-
ume of accounts receivable arising on export transactions might present administrative problems, the Internal Revenue Service has issued private rulings approving purchases of an undivided interest in the parent company’s receivables by a DISC, with the fractional interest determined by the amount of the DISC’s income that must be invested in qualified fashion. These rulings have approved a DISC’s appointment of its parent corporation as its agent for collection of the purchased receivables, as well as for the reinvestment of all proceeds of collection in continuing fractional interests in later-acquired receivables. The Service’s approval of this scheme is not too surprising, in view of the fact that a buy-sell DISC, which took title to export property and then sold it in its own name to the export customers would automatically receive the same results, because it would hold the account receivable of each export customer after each sale. It should be noted that the amount of receivables and their rate of turnover will provide a limiting factor as to the extent to which the receivable-purchase strategy may be used by a DISC. This writer’s experience indicates that a three to six year period seems to be contemplated by most DISCs and they are resigned to turning thereafter to other investment alternatives.

One further type of investment for DISC funds, attractive in many circumstances, would be the purchase of storage or other facilities used in connection with the export of merchandise from the United States. Investments of this type by a DISC, however, will be relatively unattractive in some circumstances owing to the parent’s loss of the investment credit and the reduced benefits from any depreciation taken on such facilities by the DISC.

V. CONTROLLED FOREIGN CORPORATION

A. Historical Background

Prior to 1963, the traditional foreign market arrangement was for a U.S. manufacturing company to establish a subsidiary in a low-tax country such as Switzerland and for the manufacturing company then to sell all the exports to the subsidiary, which in turn would sell to local distributors in the various countries of its market. Prior to 1963, the United States imposed no tax on the profits of the foreign corporation. Section 11 of the Code does impose the corporate income tax on the taxable income of every corporation, but this is cut back by §§ 881-82 with respect to foreign corporations, which are taxed only on their U.S.-connected income. In the case of an export company without any agents or offices in the United States, the United States would impose no tax on the profits.

1. “Business Purpose” Doctrine
Although the Internal Revenue Service did not like this corporation structure, its attack was for years limited to the “meat-ax” approaches of the judicial “business purpose” doctrine and § 269(a). Under the business purpose doctrine, the courts ignore as a sham any corporation formed solely for tax avoidance purposes which does not engage in any business activity. *Hay v. Commissioner* illustrates the successful application of this doctrine by the Commissioner in blatant tax-avoidance circumstances, but the government’s success with this doctrine in the international area has been confined to just such cases. In *Hay* a British subject resident in the United States owned appreciated stock in a domestic corporation. The individual taxpayer expatriated himself to the Bahamas. There he organized a Bermuda company and transferred his appreciated stock to it. The Bermuda company liquidated the domestic subsidiary a few months later. The Circuit Court agreed with the Tax Court that the Bermuda company had no business purpose, but only a tax avoidance purpose, so that its corporate entity should be disregarded. The application of the business purpose doctrine in such extreme circumstances, however, should not deter our hypothetical client from contemplating exporting from the United States. Since an active subsidiary will almost certainly have a business purpose—such as limiting the liability of its shareholder, creating a foreign identity, etc.—the business purpose doctrine should not present any problem for our hypothetical client’s proposed marketing subsidiary.

2. Section 269

The opinion in *Siegel*, illustrates a somewhat more refined attack on a foreign corporation which had the effect of reducing the current U.S. tax rate on its shareholders. The taxpayer was an individual U.S. citizen who formed a wholly-owned Panamanian corporation for the purpose of participating in a joint venture in Cuba to farm vegetables. The Commissioner’s first argument was that the Panamanian company should be considered a sham. The Tax Court found that this corporation had sufficient business purposes and/or business activity in its functions of limiting liability and investing in the joint venture, so that the corporation should be recognized as a viable entity. The Commissioner’s second attack was under § 269(a)(1), which empowers the Commissioner to disallow any “allowance” to a corporation, where any person acquires control thereof for the principal purpose of avoidance of federal income tax by securing the benefits of an allowance which such persons or corporations would not otherwise enjoy. The Tax Court held that the business reasons for the

---

22. 145 F.2d 1001 (4th Cir. 1944).
formation of the Panamanian corporation which led to recognition of its corporate status were sufficient to render § 269 inapplicable and that, in any event, the Commissioner had not disallowed any "allowance" claimed by the individual shareholder of the Panamanian corporation, so that § 269 was not applicable. While Siegel does not hold as a matter of law that the Commissioner could not apply § 269 to deny a foreign corporation the benefits of §§ 881-82, this case went a long way toward making § 269 an empty threat vis-a-vis the formation of tax haven subsidiaries. Today, it appears that careful lawyers acknowledge the existence of § 269, do their paperwork carefully, emphasize plenty of business (and not tax) reasons for the formation and operation of foreign subsidiaries, and then more or less forget about § 269. The Service has simply stopped applying § 269 to viable operating companies.

B. Subpart F

One explanation for the desuetude of § 269 is fairly obvious. The Revenue Act of 1962 added Subpart F (§§ 951-64) to the Code, and one of the principal effects of Subpart F is to subject "tax haven" earnings of foreign corporations controlled by U.S. persons to current U.S. taxation. For an illustration of how the detailed provisions of Subpart F work in a common situation, suppose that our hypothetical client, X Corporation, decides to form a Swiss subsidiary to do its European marketing job. The United States will not tax the Swiss subsidiary directly at all, assuming the subsidiary derives no income connected with the United States. As a foreign corporation, the subsidiary remains outside the taxing jurisdiction asserted by the Internal Revenue Code with respect to its other income. Under Subpart F, however, the domestic parent corporation is currently taxable on the export earnings of the Swiss subsidiary. A guided tour through the basic provisions of Subpart F affecting export sales will give some idea of the general operation (and complexity) of those provisions. Section 951(a)(1)(A)(i) requires a "United States shareholder" of a "controlled foreign corporation" to include in gross income for each taxable year the shareholder's pro rata share of the foreign corporation's "Subpart F income" for the year. The proposed Swiss corporation is clearly a "foreign" corporation within the meaning of § 7701(a)(5). The Swiss corporation is a "controlled foreign corporation" under § 957(a) as a foreign corporation of which more than 50 percent of the total combined voting power is owned by "United States shareholders." The domestic parent company is a "United States shareholder" within the meaning of § 951(b) because it is a "United States person" which owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the
TAXATION OF EXPORT OPERATIONS

foreign corporation. Sections 957(d) and 7701(a)(30) make clear that the term “United States person” includes a domestic corporation like our hypothetical X Corporation. Under § 952(a)(2), the “Subpart F income” which must be included in the shareholders’ gross income includes “foreign base company income.” Sections 954(a)(2) and (d), in turn, make clear that “foreign base company sales income” means income derived in connection with the purchase or sale of personal property from or to a related person, where the property is manufactured and sold for use outside the country under the laws of which the controlled foreign corporation is organized.

Consequently, purchases of items of personal property by the Swiss marketing company from X Corporation, its United States parent company, for sale in Europe outside of Switzerland will generate Subpart F income currently taxable to X Corporation. For example, if the parent corporation sells each unit to a wholly-owned Swiss marketing subsidiary for one dollar, and the Swiss company sells them to its European customers for $1.25, the subsidiary’s $.25 profit (assuming no deductible expenses) will all be taxed to the parent corporation under § 951(a)(1)(A)(i). In short, a controlled foreign corporation’s marketing subsidiary is in itself of no U.S. tax benefit, since all of its export earnings will be subject to the full 48 percent U.S. tax in the hands of the parent company.

VI. COMBINATION STRUCTURES

Having reviewed each of the individual alternative forms for the conduct of export operations, it seems appropriate to ask at this juncture whether any combination of these forms can be employed to improve the tax picture beyond that presented by any individual vehicle. Since we have ruled out use of a possessions corporation for our hypothetical client’s objective of marketing in Europe, only the DISC and WHTC themselves offer the possibility of a reduction in the U.S. tax rate. In this connection, it should be noted that the proposed DISC regulations would deny DISC benefits to the sale of any property in which a related WHTC participated, presumably on the ground that the WHTC benefits represent a “subsidy granted by the United States” within the meaning of § 993(a)(2)(B).

Unless our hypothetical client is willing to take on the government over its quite arguable interpretation of the latter section, the only corporate combination left to explore would seem to be a DISC coupled with a Foreign International Sales Corporation, or “FISC.” That is, if our hypothetical client, X Corporation, forms a wholly-owned DISC, the DISC might in turn form a wholly-owned Swiss marketing corporation which qualified as a FISC. The proposed Swiss
marketing corporation could easily qualify as a FISC within the meaning of § 993(e)(1) since its stock would be more than 50 percent owned by a DISC, its gross receipts and assets would consist of qualified export receipts and assets. Generally speaking, a FISC is simply a corporation which would qualify as a DISC but for the fact that it is foreign. Although the stock ownership of the proposed chain of corporations would run from a domestic parent manufacturing company to a wholly-owned DISC to a wholly-owned FISC, the flow of goods would be more direct. The parent corporation could simply sell its exports to the Swiss marketing subsidiary, which would in turn sell to its European customers, and the parent company would simply compensate the DISC on such sales on the commission basis described above.

The DISC-FISC chain may have a decided advantage over the alternative of using only a DISC to do the European marketing job for our hypothetical client. This is so because the chain set up in effect concentrates the subsidy effects of the DISC provisions on the manufacturing segment of the income derived from the exports in question. The marketing income, which will be earned by the Swiss selling company, will, to be sure, be Subpart F income includable in the gross income of the DISC as it is earned under § 951. Under § 993(a)(1)(E), however, this income will be a qualified export receipt and only half of such income will be included in the income of the shareholder of the DISC. Thus, only half of the marketing income will be subject to U.S. tax currently.

Consider again a hypothetical sale at $1.25 to the European customers. If the parent company's transfer price on sales to the Swiss company is $1.00 and if the marketing expenses of the Swiss company are $.10 per unit, the Swiss company will derive a net profit (assuming for simplicity no Swiss income taxes) of $.15, which will be included in the taxable income of the DISC. The combined taxable income of the parent company and the DISC will be $.27—the $1.00 transfer price minus $.60 cost of goods sold minus $.13 overhead, assuming the DISC incurs no expenses. Under the 50-50 pricing rule of § 994(a), the parent company will pay the DISC a selling commission of $.135 per unit on the export sales. The total taxable income of the DISC will thus be $.285—$.135 commission plus $.15 subpart F income. The deemed dividend from the DISC to its parent company will be $.1425, half of the DISC's taxable income. The parent company will have to include this amount, plus its manufacturing income of $.135, or a total of $.2775, in its taxable income for the year as a result of the manufacture and sale for export of one unit through the DISC-FISC chain.
If the same export transaction were handled solely by a DISC whose functions were expanded to include the European marketing efforts, a different result would be obtained. The DISC and the parent company would derive combined taxable income on the sale of one unit of $.42—$1.25 selling price minus $.60 cost of goods sold minus $.13 overhead expense minus $.10 European selling expense. The DISC will thus earn, under the 50-50 pricing rule, a commission of $.22—one half of the combined taxable income of $.42, plus $.01 representing 10 percent of the DISC’s export promotion expenses (assuming all the DISC’s expenses qualified as such). The deemed dividend from the DISC to the parent company will be $.11, one half of the DISC’s taxable income. The parent company will also realize manufacturing income of $.20 on the sale of each unit, after the DISC’s commission. The total taxable income derived by the parent company on the sale of each unit will therefore be $.31, substantially higher than the $.2775 amount currently taxable to the parent company under the DISC-FISC chain.

It is submitted that the DISC-FISC chain will prove to be more advantageous than a DISC alone in all cases other than those in which only the 4 percent pricing rule applies for purposes of determining the DISC’s commission income. In such a case, the 4 percent rule has the effect of sheltering the entire manufacturing income, when the parent company’s total profit margin is 4 percent or less. The extent of the benefits offered by the DISC-FISC chain depend in large measure on the amount of “marketing income,” which the FISC earns. This depends, in turn, on the level of transfer prices the parent company is permitted to charge the FISC, taking into account the requirements of § 482 to the effect that all inter-company transactions must be on an “arm’s-length” basis.

VII. INTERCOMPANY PRICING—SECTION 482

A. Historical Background

Section 482 confers broad power upon the Commissioner of Internal Revenue to allocate gross income of commonly controlled corporations in order to put them on a parity with uncontrolled taxpayers:

In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the . . . [Commissioner] may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, . . . if he determines that such . . . allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.24

Beginning with Asiatic Petroleum Co. v. Commissioner25 the cases

25. 79 F.2d 234 (2d Cir. 1935), cert. denied, 296 U.S. 645 (1935).
have consistently held that § 482 permits the Commissioner to allocate profits on the sale of personal property back to the seller, where necessary to prevent "milking" of the seller's profits by sales at an artificially low price to a related foreign company not subject to the full taxing jurisdiction of the United States. Asiatic Petroleum, incidentally, held § 482 constitutional, but the real development of the law in this area is quite recent. With respect to export operations, of course, the practical importance of § 482 lies in its impact on transfer pricing, since the Internal Revenue Service will scrutinize, and possibly adjust the transfer prices on sales by a domestic manufacturing corporation to a controlled subsidiary which qualifies as a possessions corporation or as a WHTC or which is a foreign corporation not subject to the taxing jurisdiction of the United States. Only a DISC is exempt from the rigors of § 482, by virtue of the special pricing rules in § 994 noted above.

Just what sort of standard does § 482 impose on transfer prices between related entities? Early case law, such as Polak's Frutal Works, Inc.,26 held that transfer prices need only be "fair and reasonable" to withstand allocation under § 482. In Frank v. International Canadian Corp.27 the Court reviewed a number of similar standards and concluded that the "arm's-length" standard contended for by the Commissioner is not the sole criterion for applying § 482. In fact, the case held that "reasonable return" was a proper standard for the District Court to use in appraising transfer prices between a domestic manufacturing company and a WHTC under § 482. The opinion of the Court of Claims in Eli Lilly & Co. v. United States28 can be read as holding that the test under § 482 is whether the "results" of the pricing policy under consideration are "reasonable." Whatever hopes these cases may have raised, however, U.S. Gypsum Co. v. United States,29 flatly rejected. The case rejected the proposition that there can be "reasonable prices," differing from arm's-length prices, which clearly reflect the income of controlled taxpayers. Subsequent cases have continued to uphold the strict arm's-length standard of the § 482 regulations.

B. The 1968 Regulations

Regulations promulgated in 1968 repeat the words "arm's-length" over and over, but give content to the phrase in the context of sales of personal tangible property between related parties by describing three alternative methods for determining arm's-length

---

27. 308 F.2d 520 (9th Cir. 1962).
28. 372 F.2d 990 (1967).
29. 452 F.2d 445 (7th Cir. 1971).
TAXATION OF EXPORT OPERATIONS

prices on such sales. The regulations rank these methods in the order of preference, so that the first must be applied if it is appropriate, and so on.

1. Comparable Uncontrolled Price Method

The first method is the "comparable uncontrolled price" method. Under it, an arm's-length price is simply the price paid in comparable uncontrolled sales—sales between unrelated persons. The theory underlying this method is obviously that such sales are the best evidence of an arm's-length price. Sales are "comparable" if the physical property and the circumstances of the sale are identical or if it is possible to make a reasonable number of adjustments to allow for differences which have a definite and reasonably ascertainable effect on price. For example, adjustments might be made to reflect differences in quality, the terms of sale, intangibles, the time of sale, the level of the market, or the geographic market involved. These terms, referred to in the regulations, are not at all self-defining and, in addition, present problems of quantification. For example, what determines the geographic market? If our hypothetical manufacturing company makes sales f.o.b. its factory in the United States, are such sales made in the U.S. market, even though destined ultimately for export markets?

The regulations recognize to a small extent the economic theory to the effect that, where the markets are separated, a seller should price to a new market by reference to the marginal costs of selling to the new market, to the extent that costs are relevant at all in the formulation of pricing policy. Treasury Regulation § 1.482-2(e)(2)(iv)\(^30\) recognizes temporary price reductions below full cost to establish or maintain a market, but the seller has to demonstrate that it would have sold at that price to an uncontrolled buyer, for example, by showing that the buyer cut its price or engaged in special promotional activity. In short, where the U.S. manufacturer wants its selling subsidiary to accumulate substantial profits abroad, not to cut ultimate prices or to incur huge promotional expenses, it is unlikely that the manufacturer can establish transfer prices by reference to its marginal costs. It is not clear whether a manufacturer could successfully maintain that unrelated wholesalers would require higher profit margins early in the life cycle of a product to finance the higher costs of meeting anticipated competition at a later time and to provide an adequate rate of return on investments in the long run. The provisions of the regulations dealing with costs simply ignore the rather typical situation that a new product in a market may require relatively little selling effort at first, but its profit margin will fall rather

quickly as competition pushes the price down and promotional activity increases.

2. Resale Price Method

If there are no comparable uncontrolled sales, the "resale price" method must be applied if the data for applying it are available, if the buyer has not added more than an insubstantial amount of value by physical alteration of the product (other than packaging, labeling, or minor assembly), or by the use of intangibles. Under this method, an arm's-length price is equal to the price charged by a related reseller to unrelated customers, reduced by an appropriate mark-up and adjusted as necessary to take into account any differences between the sales in question and the sales on which the mark-ups are based. The appropriate mark-up percentage of the resale price is defined as the gross profit, as a percentage of sales, earned by the reseller in question or by any other person on the resale of property purchased and sold in an uncontrolled transaction which is most similar to the resale in question. Resales need not be identical in order to be sufficiently similar. The regulations approve mark-up percentages determined from sales of the same general type of goods, without the necessity of close physical similarity. Other factors to be taken into account are the functions performed by the reseller, such as packaging, delivery, advertising, billing and servicing; intangibles used by the reseller such as patent, trademarks, and trade names; and the geographic market where the reseller's functions are performed. In the absence of particular individual resellers who are sufficiently comparable, the regulations permit the use of prevailing mark-up percentages in the particular industry. This must be deemed an invitation to use data from statistical sources such as the Sourcebook of Statistics of Income, which the Internal Revenue Service publishes annually. If industry statistics like this are used, however, a number of questions arise. For example, should only profitable ("with net income") companies be used or should all ("with and without income") companies be used? Should the industry as a whole be used, or should reference be made to assets categories which include companies comparable in size to the taxpayer?

3. Cost-Plus Method

The third method of the regulations is the "cost plus method." Under it, an arm's-length price is equal to the cost of producing the property, plus that cost multiplied by an appropriate gross profit percentage, with any necessary adjustments. Cost of production may be computed on a full or direct cost basis, as long as it is computed consistently for the controlled and uncontrolled sales. The appropri-
ate gross profit percentage is equal to the ratio of gross profits to cost for the seller or any other person on the uncontrolled sale most similar to the controlled sale in question. Similarity for this purpose again turns on the type of property, broadly defined by reference to: the functions performed by the seller, such as contract manufacturing, assembly, selling, servicing, or delivery; the intangible property of the seller associated with the sale, such as patents, trademarks, or trade names; and the geographic market of the seller. Again, the prevailing gross profit percentage in the industry may be used if better data are not available. Perhaps it will be hard to argue that the taxpayer's own profitability on other sales (if any) is not the best source of a gross profit percentage. This is particularly true when compared to overall industry averages, the use of which would seem to give a windfall to efficient producers while unduly penalizing inefficient producers.

4. “Other” Methods

The foregoing alternatives are not the only possibilities to be considered in the formulation and evaluation of a pricing policy. Treasury Regulation § 1.482-1(e)(1)(iii)31 says that the comparable uncontrolled price, resale price, or cost-plus method must be used unless the taxpayer can establish that, considering all facts and circumstances, some other method of pricing is “clearly more appropriate.” It may stretch the imagination somewhat to try to conceive of a situation which would not fit one of the three methods spelled out in the regulations. Nevertheless, it does seem worthwhile to consider some candidates for the “fourth method,” if for no other reason than to try to test by triangulation any results obtained under the first three methods. What candidates are there for a fourth method?

a. Formula Approaches

Cases such as Polak’s Frutal Works,32 Lilly,33 and International Canadian34 have suggested that the percentage of the combined profits which the manufacturer and selling company each receive is a relevant, if not controlling, factor. The source of this notion is not clear, but it may be Treasury Regulation § 1.863-3(b)(2) Example (2).35 This regulation provides that, for purposes of determining foreign source income attributable to a foreign marketing branch of a domestic manufacturing company, the combined taxable income of the manufacturing and marketing operations should be allocated one half in proportion to the amount of property within and without the

32. Supra note 26.
33. Supra note 28.
34. Supra note 27.
United States and one half in proportion to the amount of sales made within and without the United States. In a situation where the assets of the selling company were de minimis this formula suggests by analogy that a 50-50 split of the profits between a manufacturing corporation and a marketing corporation would be appropriate. Apart from the fact that the formula technically only applies for purposes of determining the geographic source of income—which may in principle be the same as an attempt to determine arm's-length prices between two separate corporate entities—a profit-splitting approach may suffer from the fact that unrelated parties bargaining at arm's-length may not bargain by reference to the split of profits. Indeed, such parties may not even know the amount of the overall profit to be split. The principal factor supporting such a formula approach would seem to be the administrative convenience of doing so—the methods spelled out in the § 482 regulations are simply extremely difficult to apply.

If formula approaches are relevant at all, several alternatives should be noted. The 863 regulations also provide a special allocation formula for situations involving a branch in a possession of the United States. This formula, illustrated in Revenue Ruling 71-387,\(^{36}\) allocates half of the combined taxable income on the basis of property within and without the possession and one half of the income on the basis of the total business (defined somewhat unusually as the sum of the compensation paid, purchases of goods, and gross sales) within and without the possession. Another type of formula would be a "proportionate profits" approach which would split the profits in proportion to the costs incurred by the manufacturing and marketing entities.

In all events, checking the split of profits is probably a useful exercise once a pricing policy has been established. Most exporters would worry a great deal if a pricing policy resulted in the selling company's earning 80 or 90 percent of the total profits. For example, such a situation might lead the parties (and the Internal Revenue Service) to ask whether one has been incurring expenses for the benefit of the other. It should be kept in mind that the intercompany pricing regulations under § 482 might be complied with to the letter and still result in an inappropriate split of profits, if expenses were in need of reallocation.

b. A Behavioral Approach

Mention of the fact that unrelated parties may not bargain by reference to their overall split of the profits does touch on one heretofore unexplored point. Just how do unrelated parties bargain? Perhaps behavioral science holds the key to our question of how arm's-

length prices are determined. Maybe the question should be, "How do unrelated businessmen act in a bargaining situation?" Perhaps the sides compute their out-of-pocket costs and then tend to bargain toward a position which does indeed split the resulting difference 50-50, because such an outcome maximizes the good feelings of the parties. But what if the manufacturing company simply would never let an outsider do its marketing job? Is the arm's-length price in these circumstances infinitely high?

c. Renegotiation Experience

One other possible source of arm's-length prices, or at least a useful cross-check on one's pricing policy, might be the renegotiation experience of the taxpayer or members of its industry. Under the Renegotiation Act of 1951, government contractors must repay to the government any amount necessary to eliminate "excessive profits" from contracts made with the United States. Excessive profits are determined by reference to a number of factors including the volume of production, the extent of capital employed, the risk assumed, and the character of the business. While it is not clear that "reasonable" profits are determinative of "arm's-length" prices, some would argue that renegotiable sales may well be quite comparable to the sales of a manufacturing company to a foreign or WHTC marketing subsidiary. Renegotiable sales would typically involve a large volume sold to a single customer without substantial advertising or selling costs—all factors present in the typical parent-subsidiary selling arrangement. It should be noted that the profit percentages approved by the regional offices of the Renegotiation Board, its national office, and the courts which have jurisdiction to review the Board's determinations are all a matter of public record.

d. Functional Analysis

A final mode of determining arm's-length prices might be labeled "functional analysis." Perhaps it would be possible to develop an arm's-length price between two related corporations by identifying all the economic functions performed by one of the corporations, valuing each function by reference to the cost of having that particular function performed by an unrelated person, and then summing the values (perhaps with a premium or discount for synergy). Some cases, such as Johnson Bronze Co., have listed and emphasized the various economic functions performed by a foreign marketing corporation, although none has attempted to quantify them individually. Needless to say, the quantification of all of the individual economic functions performed would undoubtedly be a difficult undertaking.

37. 1965 T.C. Memo No. 281.
e. *Two Caveats*

Throughout any search for a "method" acceptable for pricing tangible personal property under § 482 regulations, one particularly strong statement of the holding of *Lufkin Foundry & Machine Co. v. Commissioner* should be kept in mind:

No amount of self-examination of the taxpayer's internal transactions alone would make it possible to know what prices or terms unrelated parties would have charged or demanded.

Notwithstanding their obviously attractive convenience, it may be that no formula or other "internal" approach will again pass muster under § 482. Before leaving this subject, however, it might be observed that both the case law and the regulations under § 482 show an almost shocking disregard for relative rates of return on investment as an indication of the appropriateness of pricing policies. This situation is certainly out of tune with contemporary marketing and financial theory, but the law under § 482 may well someday catch up.

**VIII. CONCLUSION**

By way of conclusion, the writer regrets only that limitations of time and space have precluded a really full exploration of the alternative forms of export operations and the § 482 pricing rules which may loom so important in determining exactly what the export field has to offer a particular taxpayer. It is hoped that some of the above suggestions will prove provocative, if not directly useful.

---

38. 468 F.2d 805, 808 (5th Cir. 1972).