**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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Person to Contact:

Telephone Number:

Refer Reply To:
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Date:
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Legend:

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|---|---|
| Taxpayer | = |
| FS1 | = |
| Country A | = |
| FS2 | = |
| Country B | = |
| Country C | = |
| HP1 | = |
| Country D | = |
| HP2 | = |
| Country E | = |
| Product | = |
| Country A Tax Authority | = |
| Year 1 | = |
| Year 2 | = |
| Year 3 | = |
| a | = |
| b | = |

Dear

This responds to your request dated August 14, 2001, and supplemented by letters dated February 26, 2002, March 19, 2002, and March 27, 2002, for a private letter ruling concerning whether Taxpayer may apply the principles of Rev. Proc. 65-17, 1965-1 C.B. 833, in accordance with Rev. Proc. 99-32, 1999-2 C.B. 296, under the circumstances described below.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by penalty of perjury statements executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

**FACTS**

Taxpayer, a domestic corporation and the parent of a group of domestic and foreign subsidiaries, makes the following representations with respect to its Year 1 through Year 3 taxable years.

Taxpayer was an accrual basis, calendar year taxpayer. Taxpayer owned 100% of FS1, a company organized under the laws of Country A. Taxpayer indirectly owned (through a single holding company) 100% of FS2, a company organized under the laws of Country B and managed and controlled in Country C. FS2 owned 99% of HP1, a company organized under the laws of Country D, and 99% of HP2, a company organized under the laws of Country E. HP1 owned 1% of HP2, and Taxpayer owned 1% of HP1. FS1 and FS2 were classified as foreign corporations for U.S. federal tax purposes. HP1 and HP2 were classified as partnerships for U.S. federal tax purposes.

Taxpayer and HP2 entered into license and technical service agreements under which Taxpayer made manufacturing and marketing intangibles available to HP2 in exchange for royalties. HP2 manufactured Taxpayer-branded Product, which it sold to customers in Country E and to commonly controlled resellers located outside of Country E.

FS1 purchased Product from HP2 and resold the Product to customers in Country A. The Country A Tax Authority examined the transfer pricing between FS1 and HP2, and determined that prices paid by FS1 to HP2 for Product exceeded prices that would have been paid by uncontrolled parties in comparable uncontrolled transactions. As a result of its transfer pricing examination, the Country A Tax Authority increased FS1's gross income for its Year 1, Year 2 and Year 3 taxable years, by approximately $a, which caused an increase in FS1's Country A tax liability of approximately $b.

With respect to its Year 3 taxable year, Taxpayer will initiate transfer pricing adjustments, for U.S. federal tax purposes, by reporting on Form 1120X, Amended U.S. Corporation Income Tax Return, including amended Forms 5471, Information Return With Respect to a Foreign Corporation, the Product sales from HP2 to FS1 based on the prices determined in the Country A transfer pricing examination instead of the actual prices charged by HP2. Taxpayer will cause HP2 and FS1 to create accounts payable by HP2 and receivable by FS1 to conform the respective accounts and reflect the adjustments made by the Country A Tax Authority, in accordance with the principles of Rev. Proc. 65-17 and Rev. Proc. 99-32. The HP2 partners' distributive shares of items described in section 702(a) of the Internal Revenue Code for their taxable years ending with or within Year 1 through Year 3 were determined in accordance with the partners' interests in the partnership. Any such item reported in connection with a

Taxpayer-initiated adjustment pursuant to section 482 of the Internal Revenue Code and section 1.482-1(a)(3) of the Income Tax Regulations will be determined in accordance with the partners' interests in the partnership, i.e., HP2 will not make any special allocations of any such items.

For its Year 3 taxable year, the Form 1120X filed by Taxpayer to apply revenue procedure treatment and reflect the arm's length results of the controlled transactions will not decrease taxable income based on the Taxpayer-initiated allocations or other adjustments made with respect to the controlled transactions between HP2 and FS1. If Taxpayer filed Forms 1120X for its Year 1 and Year 2 taxable years, the amended returns would decrease taxable income based on the Taxpayer-initiated allocations or other adjustments made with respect to the controlled transactions between HP2 and FS1.

## RULING REQUESTED

Taxpayer requests a ruling by the Internal Revenue Service ("Service") that it may apply the principles of Rev. Proc. 65-17, 1965-1 C.B. 833, and its progeny, in accordance with any reasonable interpretation thereof, with respect to its tax years Year 1 through Year 3, for purposes of conforming accounts to reflect Taxpayer-initiated primary adjustments.

## LAW AND ANALYSIS

Section 482 of the Internal Revenue Code provides, in pertinent part, as follows:

> 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 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.

Section 1.482-1(a)(1) of the Income Tax Regulations states, in part:

> The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the

> true taxable income of the controlled taxpayer. This § 1.482-1 sets forth general principles and guidelines to be followed under section 482.

Section 1.482-1(a)(2) of the regulations describes the grant of authority to the Service to make allocations:

> The district director may make allocations between or among the members of a controlled group if a controlled taxpayer has not reported its true taxable income. In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

Section 1.482-1(a)(3) of the regulations provides that taxpayers may, under certain circumstances, initiate section 482 allocations:

> If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed U.S. income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions. See § 1.6662-6T(a)(2) or successor regulations.

Whether initiated by the Service or a taxpayer, the allocations referred to in section 1.482-1(a)(2) and (3) are commonly referred to as “primary allocations.” A primary allocation made in accordance with section 1.482-1(a)(3) is also referred to as a “taxpayer-initiated primary adjustment.”

Section 1.482-1(g)(1) of the regulations identifies collateral adjustments taken into account with respect to primary allocations made in accordance with section 1.482-1(a)(2) and (3). One such collateral adjustment that always results from a primary allocation is the “correlative allocation,” i.e., the allocation made with respect to any other member of a controlled group affected by the primary allocation.

Another collateral adjustment identified in section 1.482-1(g)(1) and taken into account with respect to a primary allocation is the secondary “conforming adjustment.” Section 1.482-1(g)(3)(i) describes secondary conforming adjustments:

> Appropriate adjustments must be made to conform a taxpayer's accounts to reflect allocations made under section 482. Such adjustments may include the treatment of an allocated amount as a dividend or a capital contribution (as appropriate), or, in appropriate cases, pursuant to such applicable revenue procedures as may be provided by the Commissioner (see § 601.601(d)(2) of this chapter), repayment of the allocated amount without further income tax consequences.

The secondary conforming adjustments deemed by the Service in the case of a Service-initiated section 482 allocation between brother-sister corporations are described in Rev. Rul. 69-630, 1969-2 C.B. 112. In Rev. Rul. 69-630, a common shareholder owned all of the stock of two domestic corporations, one of which sold property to the other at a bargain price. The Service allocated income to the seller under the authority of section 482 to reflect the arm’s length price that would have been charged in an uncontrolled transaction. To conform the accounts of the corporations with the primary adjustment, the Service deemed a constructive distribution with respect to the stock of the selling corporation (i.e., a dividend to the extent of available earnings and profits) to the common shareholder and a constructive contribution to the capital of the buying corporation from the common shareholder.

Rev. Proc. 65-17, 1965-1 C.B. 833, prescribes the procedures to be followed where a taxpayer, whose taxable income has been increased by reason of an allocation under section 482, requests permission to receive payment from the entity from, or to, which the allocation of income, or deductions, was made of an amount equal to a part or all of the amount allocated, without further federal income tax consequences. The Service will, in appropriate cases and pursuant to a closing agreement, permit such taxpayers to make adjustments to conform their accounts to reflect Service-initiated section 482 allocations.

Rev. Proc. 99-32, 1999-2 C.B. 296, which superceded Rev. Proc. 65-17, provides treatment similar to that provided by Rev. Proc. 65-17 (i.e., setting up of accounts to conform to section 482 allocations), but also extends the application of Rev. Proc. 65-17 to taxpayer-initiated adjustments made in accordance with section 482 and section 1.482-1(a)(3), for pre-effective date taxable years. Specifically, section 6.03 of Rev. Proc. 99-32 provides:

> A United States taxpayer that increased or decreased its taxable income pursuant to section 482 and section 1.482-1(a)(3) for a taxable year prior to the taxable year including August 23, 1999, shall be permitted to apply the principles of Rev. Proc. 65-17, 1965-1 C.B. 833, and its progeny, in accordance with any reasonable interpretation thereof for purposes of conforming accounts to reflect the taxpayer-initiated primary adjustment. The Service considers an interpretation that applies the final revised revenue procedure published in this document or its general principles to be such a reasonable interpretation of Rev. Proc. 65-17.

Thus, with respect to taxpayer-initiated adjustments made in accordance with section 482 and section 1.482-1(a)(3), for taxable years prior to the taxable year including August 23, 1999, taxpayers may apply the provisions of Rev. Proc. 99-32, without a closing agreement, as a reasonable interpretation of the principles of Rev. Proc. 65-17.

The scope of Rev. Proc. 99-32 includes primary adjustments made in connection with foreign-to-foreign controlled transactions. In that regard, section 2 of Rev. Proc. 99-32 provides, in pertinent part:

> For purposes of this revenue procedure, an increase or decrease, or an adjustment of, the taxable income of a United States taxpayer that is a domestic corporation pursuant to section 482 of the Code shall be deemed to include an allocation of an amount to, or from, a related person (being a corporation as defined in section 7701(a)(3) of the Code), from, or to, a foreign corporation that is a controlled foreign corporation within the meaning of section 957 of the Code solely by reason of ownership of such foreign corporation's stock by such domestic corporation (or any member of the affiliated group within the meaning of section 1504(a) of the Code in which such domestic corporation is included) with respect to a controlled transaction. In the latter circumstances, the parties to any account established under section 4.01 shall be such controlled foreign corporation and such related person, and for purposes of section 4.012 the requirement to accrue and include, or deduct, interest in, or from, taxable income shall mean accounting for such interest for all Federal income tax purposes that may affect the determination of the taxable income or tax liability of such domestic corporation, including, for example, the computation of earnings and profits, subpart F income, and the foreign tax credit provided

> under section 901 of the Code. [emphasis added]

The preamble to Rev. Proc. 99-32, in Section E, clarifies that "[t]ransactions with noncorporate persons, for example, a transaction between a partnership and its controlling corporate partner, are not covered by the revenue procedure, but will be the subject of further study by the Service." Thus, while allocations made with respect to controlled transactions between two controlled foreign corporations may be within the scope of Rev. Proc. 99-32, allocations made with respect to controlled transactions between a controlled foreign corporation and a related partnership are not. However, in appropriate cases, the Service may permit the application of revenue procedure treatment to allocations involving partnerships.

Section 5.02 of Rev. Proc. 99-32 sets out the procedure to be followed and the information to be provided by a U.S. taxpayer that desires to apply or elect revenue procedure treatment with respect to a taxpayer-initiated adjustment. Under section 5.02, the U.S. taxpayer must file a statement with its federal income tax return reporting the adjustment, including, in part, a statement that the taxpayer desires revenue procedure treatment for the year or years indicated. The term "return" is generally interpreted to mean a timely filed return rather than an amended return. See Goldring v. Commissioner, 20 T.C. 79 (1953); Middletown v. Commissioner, 200 F.2d 94 (5th Cir. 1952); Rev. Rul. 73-467, 1973-2 C.B. 66; Rev. Rul. 72-311, 1972-1 C.B. 398; Rev. Rul. 55-655, 1955-2 C.B. 253. Nevertheless, in accordance with section 1.482-1(a)(3), Rev. Proc. 99-32 provides that, if a taxpayer-initiated adjustment results in an increase in taxable income, the increased income may be reported by the taxpayer at any time, i.e., on a timely filed or amended return. Accordingly, Rev. Proc. 99-32 employs an expanded interpretation of the term "return" in those limited circumstances where a taxpayer-initiated adjustment increases, or does not decrease, taxable income.

A taxpayer that elects Rev. Proc. 99-32 treatment must agree to be bound by the election. Section 2 of Rev. Proc. 99-32 provides:

> The United States taxpayer is bound by its election of treatment under the revenue procedure. The taxpayer-initiated adjustment for the treatment provided under the revenue procedure will be subject to review and adjustment, and to possible imposition of the section 6662(e) or (h) penalty, by the Service upon examination.

Similarly, section 3.02 of Rev. Proc. 99-32 provides:

> A United States taxpayer described in section 5.02 shall qualify for the treatment provided in this revenue procedure, provided that the taxpayer shall be bound by its election of such treatment.

Accordingly, a taxpayer that applies the provisions of Rev. Proc. 99-32, or its general principles, as a reasonable interpretation of the principles of Rev. Proc. 65-17, for a taxable year prior to the taxable year including August 23, 1999, must agree to be bound by its application of revenue procedure treatment.

**CONCLUSIONS**

Based solely on the information submitted and the representations made, we rule as follows:

Provided all the threshold requirements are met, Taxpayer shall be permitted to apply the principles of Rev. Proc. 65-17, and its progeny, in accordance with any reasonable interpretation thereof, for purposes of conforming accounts to reflect Taxpayer-initiated primary adjustments made to the prices charged in transactions between HP2 and FS1 for the Year 3 taxable year. The Service considers an interpretation that applies the provisions of Rev. Proc. 99-32, or its general principles, to be such a reasonable interpretation of Rev. Proc. 65-17.

The amended returns that Taxpayer would be required to file to initiate the proposed Taxpayer-initiated adjustments for its Year 1 and Year 2 taxable years would decrease taxable income based on the Taxpayer-initiated allocations or other adjustments made with respect to the controlled transactions between HP2 and FS1. Section 1.482-1(a)(3) expressly provides that such amended returns will not be permitted. Accordingly, no ruling is issued with respect to those taxable years.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express no opinion regarding the following:

- Whether the amounts of consideration charged to or paid by HP2 in connection with controlled transactions, whether or not adjusted by the Country A Tax Authority, are consistent with section 482 and the arm's length standard;

- Whether the proposed Taxpayer-initiated adjustments increase, decrease, or have no effect on Taxpayer's taxable income based on allocations or other adjustments with respect to controlled transactions, within the meaning of section 1.482-1(a)(3);

- Whether the earnings and profits of FS1 and FS2, as computed for U.S. federal tax purposes, including for purposes of sections 902 and 960, should reflect the transfer prices determined by the Country A Tax Authority (see section 964(a); section 1.964-1; section 1.964-1T; and section 1.902-1(a)(9));

- Whether FS1 has exhausted all effective and practical remedies, including invocation of the competent authority procedures available under applicable

income tax treaties, to reduce its liability for foreign tax (including the Country A tax resulting from the transfer pricing examination by the Country A Tax Authority) (see section 1901-2(e)(5)(i)); and

- Whether adjustments to FS1's post-1986 undistributed earnings and to FS1's post-1986 foreign income taxes to reflect the additional Country A tax, if such adjustments are allowed, should be made for the taxable year (or years) to which the additional Country A tax relates or, pursuant to section 905(c) and the regulations thereunder, for a subsequent taxable year.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. A copy of this letter must be attached to any income tax return to which it is relevant. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer and the second representative.

Sincerely,

/s/ Elizabeth G. Beck

Elizabeth G. Beck
Chief, Branch 6
Office of Associate Chief Counsel
(International)