United States General Accounting Office

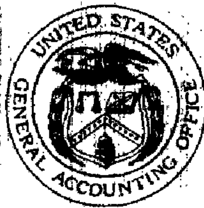
GAO

Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

February 1994

INTERNATIONAL TAXATION

IRS' Administration of Tax-Customs Valuation Rules in Tax Code Section 1059A



United States
General Accounting Office
Washington, D.C. 20548

150945

General Government Division

B-253763

February 4, 1994

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This report responds to your request for information on the Internal Revenue Service's (IRS) enforcement of section 1059A of the Internal Revenue Code (the Code). Congress enacted section 1059A in 1986 to improve IRS' enforcement of transfer pricing regulations. Section 1059A was designed to prevent the federal government from being whipsawed by an importer, on property acquired from a related party, who claims a low valuation for customs purposes and a higher valuation for tax purposes.[1] In this report we provide information on IRS' difficulties in applying the section and a July 1992 IRS legal opinion on the applicability of section 1059A to certain specific transactions that IRS found between a U.S. parent and its Mexican related parties. At the request of the Subcommittee, we also present proposals to reconcile the different IRS and U.S. Customs Service (Customs) valuation rules that affect the use of section 1059A. Our review was performed between June 1992 and November 1993 in accordance with generally accepted government audit standards (see app. I).

Results in Brief

Since its enactment in 1986, IRS has included section 1059A issues in nine tax audits. Related to one of the audits, IRS' Office of Chief Counsel issued a technical advice memorandum[2] in July 1992 on the applicability of section 1059A (see app. III). The memorandum concluded that section 1059A could not be used to prevent a U.S. taxpayer from including certain expenses in the taxpayer's cost or inventory basis for tax purposes. The expenses at issue—which included electric and telephone bills, legal and consulting fees, entertainment and travel expenses—were paid on behalf of a Mexican related party but were not subject to customs duties because

[1]Section 1059A provides that in transactions between related persons, the amount of any costs that are taken into account in computing the basis or inventory cost of imported property may not be greater than the amount of any costs that are also taken into account in computing the customs value of the property. Appendix II has the exact wording of the section.

[2]A technical advice memorandum provides advice or guidance as to the interpretation and proper application of internal revenue laws, related statutes, and regulations to a specific set of facts. The memorandum is furnished by the National Office upon request of a district office in connection with the examination of a taxpayer's return or consideration of a taxpayer's return claim for refund or credit.

they were not includible in duty valuation. We agreed with IRS' legal opinion.

We were not able to estimate the total federal revenue loss attributable to the practice of making payments on behalf of related parties because of the few cases audited by IRS, which involved mostly U.S. taxpayers with Mexican related parties. According to a November 1993 House of Representatives report, tariffs on U.S. imports from Mexico would be reduced over 15 years with approval of the North American Free Trade Agreement (NAFTA).[3] Also, the extent of the payments practices in other countries not affected by NAFTA has not been determined by the executive branch at this time. IRS and Customs officials cited resource and legal authority constraints for not collecting information on a worldwide basis to determine the full extent of direct payments practices among related parties.

Implementation of section 1059A in those situations that involve direct payments effectively ceased following the issuance of IRS' technical advice memorandum. While we agree with the IRS position that it is inappropriate to use section 1059A to disallow the practice of making direct payments on behalf of foreign related parties, we are concerned by the revenue implications of this practice. The cases examined by IRS indicate that the use of direct payments by U.S. firms may result in a net revenue loss to the federal government. Since the information necessary to estimate the worldwide extent of this revenue loss is not available, we only present in this report the various options available to reconcile the valuation differences and the agencies' comments on them without recommending a specific course of action.

There are two general options available to resolve the inconsistency in the valuation definitions that affect the use of section 1059A—multilateral renegotiation of the Customs Valuation Code of the General Agreement on Tariffs and Trade (GATT) or unilateral congressional amendment of either section 1059A of the Internal Revenue Code or section 402 of the customs

[3]North American Free Trade Agreement Implementation Act, House of Representatives, Committee on Ways and Means (Report 103-361, Part 1, Nov. 1993).

legislation (19 U.S.C. §1401a).[4] These legislative options are described in appendixes V and VI.

In response to our inquiry on legislative options, IRS' Office of Chief Counsel concluded that the issue addressed in the technical advice memorandum is not a tax problem (see app. VIII). Rather, it believed that the problem is with customs valuation, resulting from a loophole in customs legislation. Thus, IRS' Office of Chief Counsel concluded the issue should be resolved by amending customs law.

Customs, in its response to our inquiry, concluded that the two legislative options would violate GATT (see app. IX). According to Customs, the amendatory language would place the U.S. valuation legislation in conflict with the Customs Valuation Code, which was negotiated between the United States and its major trading partners.

Private sector representatives, including trade associations and businesses, generally opposed any U.S. legislative amendment because they believed it would violate GATT and they were concerned that U.S. firms might be placed at a competitive disadvantage from retaliation by GATT members.

Background

Transactions between affiliates[5] constitute a major part of U.S. merchandise trade. As shown in table 1, in 1989 U.S. merchandise exports between affiliates were $120 billion. These exports represented 33 percent of total U.S. merchandise exports. In 1989, U.S. merchandise imports between affiliates were $201 billion and represented 42 percent of U.S. merchandise imports.

[4]The valuation system used by the United States and its major trading partners was negotiated in the Tokyo Round of multilateral negotiations of GATT. The valuation agreement is known as the Agreement on Implementation of Article VII of GATT, or the Customs Valuation Code. The Customs Valuation Code was implemented into U.S. law through the Trade Agreements Act of 1979, which amended section 402 of the Tariff Act of 1930. Section 402 provides various methods for computing the value of imported items and defines the terms used in the section, including the term "assist."

[5]A foreign affiliate is a foreign business enterprise in which there is direct U.S. investment, that is, in which a U.S. person owns or controls 10 percent or more of the voting securities or the equivalent.

Table 1: Merchandise Trade Between Affiliates: U.S.-Controlled Corporations Dominated U.S. Exports and Foreign-Controlled Corporations Dominated U.S. Imports in 1989

Dollars in billions

	U.S. exports	U.S. imports
U.S.-controlled corporations		
From U.S. parent to foreign affiliate	$86	NA
From foreign affiliate to U.S. parent	NA	$71[a]
Foreign-controlled corporations		
From foreign parent to U.S. affiliate	NA	130
From U.S. affiliate to foreign parent	34	NA
Total	**$120**	**$201**

[a]Imports from Canada shipped by foreign affiliates to their U.S. parents were $33 billion, or 46 percent of $71 billion. Imports from Mexico shipped by foreign affiliates to their U.S. parents were $6.4 billion, or 9 percent of $71 billion. Seven of nine cases audited by IRS under section 1059A would be in this latter group.

Source: U.S. Department of Commerce.

According to IRS officials, manipulation of intercompany transactions can take various forms. For example, setting prices too high or too low in a related party transaction can result in income being shifted from one country to the other and taxes being avoided. In another example, allocating costs between related and nonrelated parties that both contribute to adding value to the product can result in lowering the duty valuation of the imported item and duties being avoided. Section 1059A was enacted in 1986 to improve IRS' enforcement of related party transactions. Appendix II provides the complete text of section 1059A. When section 1059A was enacted, the revenue estimates were that it would raise less than $5 million annually.

The legislative history of the section indicates that the section was intended to address the Tax Court holding of Brittingham v. Commissioner.[6] In this case, IRS determined that a U.S. importer paid more than an arm's length price[7] for ceramic tile imported from a related party in Mexico. The purchase price exceeded the value reported for customs duty purposes. The court held, however, that the IRS Commissioner acted unreasonably in determining that the customs value constituted an arm's length price for the sale.

[6]66 T.C. 373 (1976), aff'd 598 F.2d 1375 (5th Cir. 1979).

[7]An arm's length price is the price one unrelated party charges another unrelated party for a product or service. See International Taxation: Problems Persist in Determining Tax Effects of Intercompany Prices (GAO/GGD-92-89, June 15, 1992).

The legislative history indicates that Congress understood that Brittingham supported the proposition that some importers could claim a transfer price for income tax purposes that was higher than would be consistent with the transfer price claimed for customs purposes. It also states that Congress was particularly concerned that such practices between related parties could improperly avoid federal tax or customs duties.

Although Congress was concerned about tax and duty avoidance, the legislative history notes that Congress did not express the view that valuation of property for customs purposes should always determine valuation of property for federal income tax purposes. Congress acknowledges that the Secretary of the Treasury would provide rules for coordinating customs and tax valuation principles when customs pricing rules may differ from appropriate tax valuation rules. Treasury regulations to provide the public with guidance needed to comply with section 1059A were issued September 8, 1989.[8]

Few IRS Audits Have Involved a Section 1059A Issue

According to IRS officials, since 1986 IRS has raised section 1059A issues in nine audits. Furthermore, when raised in audits, its application has been primarily directed at taxpayers operating under the maquiladora program—U.S.-owned manufacturing and assembly operations in Mexico (maquiladoras) that export their products back to the United States. About 2,100 maquiladoras exported products to the United States in 1991.

According to IRS officials, in a maquiladora operation the U.S. firm establishes a related party operation (the maquiladora). The U.S. firm establishes a contract in which the maquiladora supplies a product and the U.S. firm pays for the product. The U.S. firm may also make direct payments to other Mexican firms that cover some of the maquiladora's operating costs. For example, the U.S. firm may pay a Mexican electric company for the electricity used by the maquiladora. For tax purposes, the U.S. firm would claim its total costs, including this direct payment, as a deductible expense. However, for customs valuation purposes, only the costs on the maquiladora's books (excluding, for example, the electrical

[8]Treasury regulations to provide foreign-owned U.S. corporations and foreign corporations engaged in a U.S. trade or business with guidance to comply with the information reporting and records maintenance requirements of the Code, including the reporting of imports from related parties and their valuation for tax and duty purposes, were issued June 19, 1991. This information is reported in Part VI of IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (see app. IV). IRS Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, does not contain a similar reporting requirement.

payment) would be declared as dutiable value added by the Mexican operation.

Seven of the nine cases IRS identified in which it included section 1059A issues as part of an audit involved firms associated with the maquiladora program. In two of the nine cases, the taxpayer agreed to the IRS adjustment. In two cases, IRS is pursuing the issue. In a fifth case, IRS withdrew the section 1059A issue following the sale of the firm. In the remaining four cases, IRS withdrew the section 1059A issues after its July 1992 technical advice memorandum found that the legal basis for its proposed income adjustment could not be justified.

Different IRS and Customs Valuation Rules Prompted IRS' Technical Advice Memorandum

In general, according to IRS officials, IRS district offices proposed to use section 1059A to disallow the deductions for expenses paid by U.S. parents on behalf of their foreign related parties when they were not reflected in the customs valuation for the items imported from the related foreign parties. Thus, IRS auditors adjusted the parent's income and tax due accordingly. According to an IRS official, taxpayers took the position that the transactions were in accordance with Treasury regulations for section 1059A and the duty valuation provisions of the customs legislation.

Tax Valuation Rules

Section 1059A provides that in transactions between related persons, the amount of any costs that are taken into account in computing the basis or inventory costs of imported property may not be greater than the amount of any costs that are also taken into account in computing customs value of the property. The Treasury regulations for section 1059A provide that taxpayers, in determining the limitation on claimed basis or inventory cost of property, may increase the customs value of imported property by certain amounts. Four types of adjustments are cited in the regulations:

- freight charges;
- insurance charges;
- the construction, erection, assembly, or technical assistance provided with respect to the property after its importation into the United States; and
- any other amounts that are not taken into account in determining the customs value, that are not properly includible in customs value, and that are appropriately included in the cost basis or inventory cost for income tax purposes.

Customs Valuation Rules

Under the Trade Agreements Act of 1979, the customs value is generally the transaction value of imported merchandise. Generally, it is the price paid or payable by the importer for the merchandise plus amounts equal to (1) packing costs; (2) selling commissions paid by the buyer; (3) royalties or license fees paid by the importer as a condition of sale; (4) the proceeds of any subsequent use of the imported merchandise that accrue to the seller; and (5) the value of any "assists," which are defined below. If the transaction value method cannot be used, secondary valuation methods are to be considered.

List of Assists Does Not Include Contested Expenses

Essentially, according to IRS officials, the question raised by the IRS audits was what expenses make up dutiable value. Specifically, the technical advice memorandum addressed what expenses qualified as assists in computing transaction value. Customs had generally defined assists as various general purpose equipment expenses and direct manufacturing equipment expenses. In response to IRS' questions about what is included in transaction value, Customs advised IRS that general, administrative, and overhead expenses are not assists. The following list, obtained from IRS' technical advice memorandum of July 10, 1992, contains the foreign related party expenses that IRS proposed to disallow that Customs subsequently advised IRS were not assists:

- office equipment rental fees,
- automobile depreciation,
- landscaping,
- janitorial supplies,
- office supplies,
- business expenses,
- electric bills,
- safety/medical expenses,
- telephone bills,
- postage expenses,
- removal of trash,
- legal fees,
- classified advertising,
- executive development,
- travel and entertainment expenses,
- professional dues and subscriptions,
- charitable contributions,
- consulting fees, and
- expenses attributable to conversion of currencies.

On the basis of the differences between how IRS and Customs interpreted this aspect of duty valuation, an IRS district office requested technical advice from the IRS Office of Chief Counsel on the issue. The technical advice memorandum was issued on July 10, 1992, after consultations with Customs.

The memorandum concluded that IRS could not apply section 1059A to prevent the U.S. taxpayer from including the expenses paid on behalf of its foreign related party in its cost basis because the expenses were not subject to customs duty. This reasoning was based on Customs' prior determination that the expenses were not assists includible in dutiable value and on IRS' own recognition that the expenses were the kind of items that were properly includible in cost basis for federal tax purposes. The memorandum concluded that the taxpayer was not prevented by section 1059A from including the expenses in its cost basis. We agree with the technical advice. Following issuance of the memorandum, IRS officials said the section 1059A issues were withdrawn from those ongoing audits in which adjustments would be inconsistent with the memorandum's conclusions. IRS and Customs officials have also discussed the possibility of administratively resolving this difference in valuation rules.

Conditions That May Lead to Reduced U.S. Government Revenues When Payments Are Made on Behalf of a Foreign Related Party

On the basis of facts presented in IRS' technical advice memorandum and discussions with IRS officials knowledgeable about the maquiladora industry, we prepared an illustration of a U.S. parent firm and its Mexican maquiladora to show what happens to government and business revenues when the U.S. parent pays a portion of its maquiladora's expenses.

Maquiladora Illustration

In the maquiladora illustration shown in appendix VII, we assumed that (1) a U.S. parent had a Mexican maquiladora under a cost-plus contract that paid 5 percent of total costs; (2) total maquila expenses were $20 million, of which $10 million were duty-free and $10 million were dutiable expenses incurred in Mexico; (3) the U.S. parent was able to pay half of the amount of dutiable expenses ($5 million) on behalf of the maquiladora and deduct the same amount for U.S. tax purposes; (4) the maquiladora did not declare dividends; (5) the Mexican corporate income

tax rate was 35 percent; (6) the top U.S. corporate income tax rate was 34 percent; and (7) the customs duty rate on the maquiladora's imports was 4 percent.[9]

The first assumption reflects the situation of a maquiladora that functions as a cost center, not as a profit center. While wage costs are lower in Mexico than in the United States, the Mexican tax rate (35 percent) is greater than the top U.S. tax rate (34 percent). Thus, the U.S. parent would not necessarily have an incentive to report a high level of taxable income in Mexico. The second assumption reflects the fact that many U.S. imports from the maquiladoras benefit from U.S. tariff provisions that allow manufacturers that assemble or process U.S. components abroad for reexport to the United States to pay duties only on that portion of the product's value that is added abroad, not on the product's final value.

Using the above figures, we compared a baseline situation in which the parent and the maquiladora pay their respective expenses with a situation in which the U.S. parent pays half of the dutiable expenses ($5 million) of the maquiladora. The results of our comparison show that when the parent pays half of the maquiladora's dutiable expenses there would be an overall loss of U.S. government revenues of about 2 percent of the baseline's revenues, and the sum of the parent and the maquiladora's net incomes would increase by about 3 percent over the baseline's combined net income. The following are the specific revenue results explained in appendix VII:

- U.S. government: U.S. revenues from customs duties would decline by $210,000—a 48-percent loss. This is because the value of the imports on which the duties are due dropped from $11 million to $5.75 million, and customs duties are 4 percent of the value of the dutiable imports. The value of the imports fell because the U.S. parent's $5 million expense payment (and an accompanying 5-percent markup for the cost-plus foreign related party) was no longer included in the import value.

  Partially offsetting decreased customs duties, U.S. tax revenues would rise by $156,400—a 6-percent increase. This rise would result from the U.S. parent's income before taxes increasing by almost $500,000. U.S. income before taxes rose because customs duties (which are a deductible expense) went down and so did the U.S. parent's overall payment to the foreign related party. The overall payment declined because the U.S.

[9]The illustration does not represent a specific taxpayer. However, according to an IRS official, the assumptions used in this example reflect the characteristics raised in the IRS audits.

parent did not have to pay the 5-percent markup that would have gone with the $5-million payment if the payment were made directly to the foreign related party. Because the additional U.S. tax was smaller than the loss in customs duties, the U.S. government would lose about $54,000.

- Foreign government: Mexico's direct tax revenues from the maquiladora would decrease by 25 percent—from $350,000 to $262,500. This decrease results from the maquiladora receiving less in direct revenue from the parent. Although we did not obtain the views of Mexico's tax officials on the reduced tax revenues from the maquiladora, we believe that their response to the revenue effect would be in part determined by the significance of the other benefits of the maquiladora program, such as its role as a source of manufacturing employment, foreign exchange, and foreign technology.
- Corporation: The combined savings in customs duties and foreign income taxes are greater than the additional U.S. income tax liabilities. As a result, corporate net profits (U.S. parent and maquiladora) would increase about $140,000—from $5.64 million to $5.78 million.

We were not able to estimate the total revenue loss to the U.S. government from the practice of making payments on behalf of foreign related parties. In order to do so, we would need to know the extent to which U.S. parent companies make payments on behalf of their foreign related parties and the extent to which foreign parent companies make payments on behalf of their U.S. related parties. The extent of the payment practices by these two groups could not be ascertained from the few cases that so far had been audited by the IRS, which involved mostly Mexican maquiladoras. In addition, according to the November 1993 House of Representatives report on NAFTA, the tariffs on U.S. imports from Mexico would be reduced over 15 years with the approval of NAFTA. Further, we do not know the extent of businesses' use of direct payments in other countries whose imports will not be affected by NAFTA since this information had not been collected by the executive branch at the time of our review.

Options for Resolving Inconsistency

There are two general options available to resolve the inconsistency in the valuation definitions—multilateral renegotiation of the Customs Valuation Code of GATT or unilateral amendment of either section 1059A of the Internal Revenue Code or section 402 of the customs legislation (19 U.S.C. §1401a). Both options have advantages and disadvantages.

Under the GATT option, the executive branch could attempt to renegotiate the duty valuation provision to reconcile the difference in valuation definitions. Following agreement, Congress would then enact the revised provision into customs legislation. This option has the advantage of reconciling the difference within the GATT structure and avoiding unilateral actions that would likely be viewed by other GATT members as violations that could encourage retaliation. Among the disadvantages of this approach are that it could be time consuming, and there is no guarantee of agreement.

Under one alternative of the legislative option, section 1059A could be amended to reconcile the duty valuation difference. A new subsection would specifically disallow adjustments for amounts paid by an importer for operating expenses that are not reflected in customs valuation. Thus, a taxpayer could not make adjustments to cost basis for an expense that did not qualify as an assist and was not reflected in duty value. Appendix V provides the legal citation and legislative language for this change.

Under the other alternative, section 402 of the customs legislation could be amended in one of two ways. One way would be to amend the definition of the term "transaction value" or "computed value" found in section 402 to specifically include those expenses paid on behalf of the foreign related party but not reflected in the customs valuation.[10] The other way would be to amend the definition of the term assist found in section 402(h)(1) to specifically include these expenses.[11] Appendix VI provides the legal citation and legislative language for these changes.

If either section 402 alternative were enacted, these expenses would have to be taken into account in determining customs value, thereby increasing the dutiable value of the imported merchandise for customs purposes. If such expenses were not included by the importer in the customs valuation of the imported merchandise as required, inclusion of these expenses in cost basis could be disallowed and IRS could make adjustments.

While either the section 1059A option or the section 402 option could reconcile the differences in duty value definitions, they are not without disadvantages. They would be considered a violation of GATT and could provide the impetus for some form of retaliation by other GATT members.

[10]A change to the definition of the term transaction value would not apply to imported merchandise that is appraised on the basis of deductive value or computed value rather than transaction value.

[11]A change to the definition of the term assist would not apply to imported merchandise that is appraised on the basis of deductive value rather than transaction or computed value.

No estimates are available on the specific revenue impact of adopting either of these alternatives.

Views on the Alternatives

We obtained views on the legislative options from IRS and Customs officials and private sector representatives, including trade associations and businesses.

In response to our inquiry on legislative options, IRS' Office of Chief Counsel concluded in a January 7, 1993, letter that the issue addressed in the technical advice memorandum is not a tax problem. Rather, it believed that the problem is with customs valuation that results from a loophole in customs legislation. The letter concluded the issue should be resolved by amending customs law.

The letter also noted two potential problems with amending section 1059A to eliminate the differences in valuation between IRS and Customs. First, an amendment to section 1059A would mean that the issue would not be resolved in all cases, since section 1059A applies only in related party transactions. Second, if section 1059A is amended as proposed without a corresponding change to customs laws, taxpayers would have to overpay customs duties to avoid an income tax problem. See appendix VIII for the text of IRS' comments.

In a letter dated January 21, 1993, Customs addressed whether an amendment to the customs law relating to dutiable value would violate GATT. The letter notes that the valuation system that Customs and our major trading partners use to appraise imported merchandise was negotiated during the Tokyo Round of multilateral negotiations within GATT. The resulting valuation agreement, the Customs Valuation Code, is now found in 19 U.S.C. §1401a.

Customs' letter concluded that the two alternatives for amending 19 U.S.C. §1401a would in fact violate GATT. According to Customs, the amendatory language would place the U.S. valuation legislation in conflict with the Customs Valuation Code. See appendix IX for the text of Customs' comments.

Private sector representatives, including trade associations and businesses, generally opposed any U.S. legislative amendment that would change their current business practices. Their main reasons for objecting were that the amendment would be a violation of GATT, and they were

concerned that U.S. firms might be placed at a competitive disadvantage from retaliation by GATT members.

Agency Comments

IRS, Treasury, Customs, and the Office of the United States Trade Representative (USTR) provided comments on the report. The four agencies did not agree on a common approach to resolving the problem of the inconsistencies in valuation definitions. The full texts of their comments appear in appendixes X through XIII.

IRS commented that a formal IRS-Customs Policy Board was chartered during the latter part of 1992 to identify issues to be commonly addressed, provide oversight and guidance for the formulation and development of major initiatives, identify and address barriers that impede cooperation between IRS and Customs, and do other tasks. IRS also commented that it has signed a formal working agreement with Customs providing for mutual assistance and the exchange of information that could be helpful in potential section 1059A issues, and it emphasized the problems with the application of section 162 of the Internal Revenue Code to disallow deductions for the expenses or reallocate them to the foreign related party.

We believe that improving the exchange of information between the two agencies could, if done systematically and on a worldwide basis, reveal the extent of the practice of making direct payments on behalf of a foreign related party. However, IRS and Customs would still not have the legal means to resolve the issues raised by the practice of making direct payments. Regarding the possibility of using section 162 as a substitute for section 1059A, we have determined that the IRS district office that was pursuing this option is no longer doing so. The report has been revised to reflect this.

Regarding the method of valuation observed in the maquiladora cases, IRS incorrectly stated that in all these cases duty was imposed on the basis of computed value. These cases involved a mix of transaction and computed valuation. However, we agree with the thrust of the IRS comments that a change in the definition of "transaction value" and the definition of "assist" as it applies to transaction value would not effectively amend the definition of dutiable value used by IRS in all of the audits in question. We have revised the option amending the definition of dutiable value to reflect these concerns.

IRS repeated its January 1993 position that it is inappropriate to solve a customs problem through a change in tax law. IRS stated that in the cases that it has seen there has not been an underpayment of federal income tax, and any federal revenue loss in these transactions has been in customs duties. Accordingly, IRS stated that the problem should be solved by modifying the customs laws or regulations, not section 1059A.

Treasury stated that a solution to the direct payments practice described in our report is to modify customs law and not tax law and suggested amending the rules with respect to the definition of an "assist" that is dutiable under the customs laws. According to Treasury, the option of amending section 1059A to prevent the evasion of customs duties would lead to two undesirable consequences. First, taxpayers would be obligated to pay more customs duties than is legally required if they wish to avail themselves of deductions for all expenses that normally are deductible as costs of goods sold. Second, if taxpayers do not include such expenses in dutiable value, deductions would be denied for expenses that otherwise are clearly deductible as costs of goods sold.

USTR stated it shared Customs' and private sector representatives' concerns that unilateral amendment of section 402 would be inconsistent with GATT's Custom Valuation Code and could result in a GATT challenge and possible retaliation by GATT members. Regarding the GATT renegotiation option, USTR noted the December 15, 1993, date for notifying Congress of the President's intention to enter into an agreement. Because of this time limit, USTR stated it would not be feasible at this stage of the current round of multilateral trade negotiations to introduce for renegotiation as complex an issue as direct payments made on behalf of a foreign related party. It also suggested further economic study of the proposed changes prior to negotiations.

Customs commented that it had made the preliminary determination that it could administratively resolve many of the valuation issues identified in the report, but did not explain how the issues will be resolved administratively. Customs also stated that it was willing to work with IRS to determine if differences in their respective statutes' interpretations could be narrowed, and it cautioned that any results would have to be coordinated with USTR prior to beginning what it viewed as a possibly lengthy implementation process. While we cannot determine whether Customs administrative approach will resolve this issue, we support Customs' willingness to pursue jointly with IRS actual audits and legal reviews. We also clarified our report to address Customs' concerns that

our discussion of transaction value and computed value could create confusion.

After we received the agencies' comments, we met with Customs and IRS officials to obtain their views on the possibility of obtaining additional information to determine the extent of the federal revenue loss caused by the direct payments practice. They cited resource and legal authority constraints for collecting information on a worldwide basis. Customs officials stated that their auditors generally do not have access to tax information unless importers voluntarily provide tax data during a Customs audit.[12] Also, the Customs officials stated that Customs audits are limited to customs matters, such as declarations of value and duty assessments. An IRS official stated that there is currently insufficient evidence of a revenue loss to justify the expenditure of scarce resources to determine the worldwide extent of the practice of making direct payments on behalf of foreign related parties.

Conclusion

Implementation of section 1059A in those situations that involve direct payments effectively ceased following the issuance of IRS' technical advice memorandum. While we agree with the IRS position that it is inappropriate to use section 1059A to disallow the practice of making direct payments on behalf of foreign related parties, we are concerned by the revenue implications of this practice. The potential federal revenue loss is not known since the executive branch has only done a small number of audits of direct payments practices. Furthermore, Customs and IRS officials cited legal and resource constraints for not determining the full extent of the federal revenue loss.

The two general options presented in this report would reconcile the valuation differences, but each has major disadvantages. Multilateral renegotiation of the Customs Valuation Code of GATT would be time consuming with no guarantee of agreement. Unilateral amendment of either tax or customs legislation would be viewed as a violation of GATT.

Furthermore, the four executive branch agencies associated with this issue do not agree on what legislative approach should be used to reconcile the valuation differences. Treasury and IRS oppose amending the tax code and prefer amending section 402 of customs legislation. Customs and USTR oppose amending section 402 of the customs legislation and do

[12]According to the North American Free Trade Agreement Implementation Act report of the Committee on Ways and Means (Report 103-361, Part 1), the NAFTA Implementation Act would permit the IRS to disclose tax information to Customs.

not state an opinion on amending tax law. Also, under current conditions the executive branch and Congress do not have the information necessary to determine the extent of federal revenue losses due to the payments practice, and IRS has been left without the use of section 1059A in those situations involving direct payments on behalf of related parties.

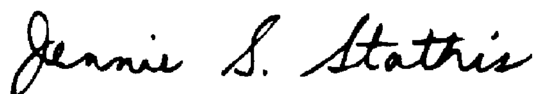
Recommendation

We are not making a recommendation in this report.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days after the date of this letter. At that time, we will send copies of the report to the Secretary of the Treasury; the Commissioners of IRS and Customs; the United States Trade Representative; the Director, Office of Management and Budget; and other interested parties. We will also make copies available to others upon request.

If you or your staff have any questions concerning matters discussed in this report, please contact me on (202) 512-5407. Major contributors to this report are listed in appendix XIV.

Sincerely yours,



Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Contents

Letter	1
Appendix I Objectives, Scope, and Methodology	22
Appendix II Text of Section 1059A	23
Appendix III July 10, 1992, IRS Technical Advice Memorandum on the Applicability of Section 1059A Published as Private Ruling 9301002	24
Appendix IV IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business	38

Appendix V
Option for Excluding From Transfer Price Certain Operating Expenses of Foreign Manufacturer Paid Directly by Importer Under Section 1059A 42

Appendix VI
Options for Including in Dutiable Value Certain Operating Expenses of Foreign Manufacturer Paid Directly by Importer 43

Appendix VII
Maquiladora Case 45

Appendix VIII
Comments From the Internal Revenue Service on Amending Section 1059A of the Code 51

Appendix IX Comments From the U.S. Customs Service on Amending Section 402 of the Customs Legislation 55

Appendix X Comments From the Office of the United States Trade Representative 58

Appendix XI Comments From the U.S. Customs Service 60
GAO Comments 64

Appendix XII Comments From the Internal Revenue Service 65
GAO Comments 68

Appendix XIII Comments From the Treasury Department 69
GAO Comments 72

Appendix XIV Major Contributors to This Report 73

Tables

Table 1: Merchandise Trade Between Affiliates: U.S.-Controlled Corporations Dominated U.S. Exports and Foreign-Controlled Corporations Dominated U.S. Imports in 1989 4
Table VII.1: How Profits Increase and Government Revenues Decrease if U.S. Parent Pays $5 Million of Foreign Related Party's Expenses 46
Table VII.2: Maquiladora's Baseline Case 47
Table VII.3: U.S. Parent Pays $5 Million of Foreign Related Party's Expenses 49

Abbreviations

GATT	General Agreement on Tariffs and Trade
IRS	Internal Revenue Service
NAFTA	North American Free Trade Agreement
USTR	United States Trade Representative

Objectives, Scope, and Methodology

Our objectives were to (1) provide information on IRS' implementation of section 1059A of the Internal Revenue Code and on specific cases in which it was used as identified in the IRS Commissioner's Quarterly Report; (2) provide information on IRS' July 10, 1992, technical advice memorandum on the applicability of section 1059A; (3) develop an illustration of the likely impact on U.S. revenues of the practice of allowing U.S. taxpayers to make payments on behalf of their foreign related parties; and (4) develop legislative language to make IRS and Customs valuation definitions consistent with each other.

To provide information on IRS' implementation of section 1059A and the IRS technical advice memorandum, we interviewed IRS and Customs officials at their respective national offices and IRS field personnel in Austin and San Antonio, Texas. The IRS September 1991 Quarterly Report identified six IRS audits involving section 1059A issues. We discussed development and disposition of the section 1059A issues in five of the six cases with cognizant IRS officials. Upon examination, we found that the sixth case had been erroneously reported as having a section 1059A issue. We discussed four other section 1059A cases not identified in the report. We also discussed the impact of the technical advice memorandum on the existing cases and the future development of section 1059A issues in IRS audits.

We constructed a specific illustration to show the possible impact on U.S. revenues, foreign tax revenues, and corporate revenues of the situation discussed in IRS' technical advice memorandum (see app. VII). We did not have sufficient information to generalize from the eight audits involving section 1059A issues to obtain an aggregate estimate on U.S. revenues.

In order to develop legislative language, our Office of General Counsel reviewed the IRS technical advice memorandum and developed language to amend legislation to address the valuation difference identified in our work. We also discussed the potential overall impact of amending legislation with IRS and Customs officials and with private sector representatives. We did not perform a revenue estimate of the impact of adopting the alternatives.

Text of Section 1059A

IRC § 1059A. LIMITATION ON TAXPAYER'S BASIS OR INVENTORY COST IN PROPERTY IMPORTED FROM RELATED PERSONS

(a) IN GENERAL.— If any property is imported into the United States in a transaction (directly or indirectly) between related persons (within the meaning of section 482), the amount of any costs—

(1) which are taken into account in computing the basis or inventory costs of such property by the purchaser, and

(2) which are also taken into account in computing the customs value of such property, shall not, for purposes of computing such basis or inventory cost for purposes of this chapter, be greater than the amount of such costs taken into account in computing such customs value.

(b) CUSTOMS VALUE; IMPORT.— For purposes of this section—

(1) Customs value.— The term "customs value" means the value taken into account for purposes of determining the amount of any customs duties or any other duties which may be imposed on the importation of any property.

(2) Import. — Except as provided in regulations, the term "import" means the entering, or withdrawal from warehouse, for consumption.

July 10, 1992, IRS Technical Advice Memorandum on the Applicability of Section 1059A Published as Private Ruling 9301002

PRIVATE RULING 9301002

INTERNAL REVENUE SERVICE NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

"This document may not be used or cited as precedent. Section 6110(j)(3) of the Internal Revenue Code."

SECTION 1059A
Limitation on Taxpayer's Basis or Inventory Cost in Property Imported from Related Persons

-- Property Subject to Limitation

Issues:

1. Whether a taxpayer, Corp A, that arranges for assembly labor in Mexico, that does not take title to the property, but that is the importer of record for Customs' purposes, is subject to I.R.C. § 1059A?

2. Assuming that section 1059A applies to Corp A, whether the Code section prevents taxpayer from claiming a cost of goods sold deduction for certain expenses that it paid on behalf of the foreign manufacturer and that are not reflected on the books and records of the manufacturer?

Facts:

1. In general.

Corp A was incorporated in California in 1971; all of the outstanding stock of taxpayer is owned by five individuals. During its 1987 taxable year, Corp A had 10 wholly-owned Mexican subsidiaries. The business of 9 of the subsidiaries was to assemble electronic products; the tenth subsidiary, which was sold in 1988, provided administrative services to the other subsidiaries. All 10 of the subsidiaries were incorporated in Mexico, operated under Mexico's maquiladora program, and will be referred to herein as maquilas.

Corp A is not in the business of manufacturing any product for itself. Rather, Corp A contracts with unrelated U.S. manufacturers of electronic products for the manufacture/assembly of the products by one of Corp A's maquilas. Under a typical

contract between Corp A and a U.S. manufacturer, the latter provides machinery and equipment to one of the former's maquilas; the U.S. manufacturer retains title to the equipment and machinery which the maquila uses to manufacture/assemble a product. The U.S. manufacturer also provides the maquila, usually through Corp A, with most materials used in the manufacturing/assembly process; and the U.S. manufacturer retains title to the material. After manufacture or assembly by the maquila, the finished product is shipped through Corp A to the U.S. manufacturer.

Corp A has a contract with each of its maquilas. A contract is for an indefinite term. Typically, under the contract, the maquila agrees to accept from taxpayer "raw materials and all the materials needed" to perform assembly operations in accordance with instructions received from Corp A. The price of the maquila's services is determined for each purchase order and is calculated from an estimate of the costs and expenses and a reasonable profit margin.

A contract between Corp A and an unrelated U.S. manufacturer is based on an estimate by Corp A and the maquila of the cost of assembling the U.S. manufacturer's product, plus a reasonable profit margin. The estimate includes all direct and indirect costs of Corp A and of the maquila, including U.S. customs duties to the extent that Corp A is responsible for such duties.[1] The estimate of costs and profit is condensed into a price for a "labor hour," the basis on which Corp A issues weekly bills to the U.S. manufacturer.

Generally, on a weekly basis, Corp A will bill the U.S. manufacturer for the number of labor hours applied by a maquila to the assembly operation during the previous week; upon issuing the bill, Corp A credits Accounts Receivable with the amount of the bill. When Corp A receives payment from the U.S. manufacturer, Corp A credits the amount of the payment to Sales and debits Accounts Receivable. Also on a weekly basis, Corp A advances the maquila funds representing an already budgeted

---

[1]The portion of U.S. customs duties for which Corp A is responsible is not the same in every contract. In some cases, Corp A is responsible for duties on the value of labor employed in manufacturing the product in Mexico and the U.S. manufacturer is responsible for the value of non-U.S. material added to the product in Mexico. Since Corp A pays all duties when the product is imported into the U.S., the portion of the duties for which the U.S. manufacturer is responsible is billed to the manufacturer by Corp A as a separate item and is not included in the hourly rate.

estimate of the maquila's expenses for the coming week. Taxpayer debits the maquila's Advance Account and credits Cash. On a monthly basis, the maquila bills Corp A for all direct and indirect labor expenses (i.e., labor hours) actually incurred during the previous month. The amount of the maquila's bill is recorded by Corp A as a debit to Account No. * * * and a credit to the maquila's Advance Account. Account No. * * * is cost of sales and is the basis for the amount of cost of sales reflected on its income tax returns.

Corp A is responsible for filing all U.S. Customs forms and for paying all duties, upon importation into the U.S. of a product manufactured/assembled by one of taxpayer's maquilas. As previously indicated, in most of the contracts between Corp A and an unrelated U.S. manufacturer, the customs duty on the value of labor added in Mexico is included in the computation of the labor hour for which the U.S. manufacturer is billed; and the customs duty on the value of materials of foreign manufacture is paid to Customs by Corp A but is then billed by Corp A to the U.S. manufacturer as a separate item.

As the importer of record, Corp A computes customs values for the articles imported from its maquilas and pays the customs duties it computes to be due. Corp A does not use the actual amount paid or payable by the third-party manufacturer[2] as dutiable value but rather a value equal to the sum of

"1. the direct labor in Mexico,

2. manufacturing overhead incurred by the maquila,

3. value of expenses that Corp A considers to be assists, and

4. dutiable material."

---

[2]The actual amount paid by the third-party manufacturer would include the total amount paid by the third-party to Corp A and the expenses of the maquila as well as the expenses of Corp A. While Customs regulation 152.103(a)(2) defines an indirect payment that is includible in transaction value as including "the settlement by the buyer, in whole or in part, of a debt owed by the seller . . .", Customs takes the position that this regulation does not apply to the expenses of the maquila that are paid by Corp A, except under limited circumstances described below.

That is, Corp A contends that its maquila is providing assembly services within the meaning of Customs regulation 152.103(a)(3). Section 1401a of Title 19 provides that dutiable value of imported merchandise is the amount paid or payable "when sold for imported merchandise is the amount paid or payable "when sold for exportation to the United States", plus certain additional amounts.

Section 152.103(a)(3) of the Customs regulations deals with the transaction value of assembled merchandise and provides that

> "[t]he price actually paid or payable may represent an amount for the assembly of imported merchandise in which the seller has no interest other than as the assembler. The price actually paid or payable in that case will be calculated by the addition of the value of the components and required adjustments to form the basis for the transaction. [Emphasis added.]"

It is regulation section 152.103(a)(3) that Corp A contends supports its position that dutiable value includes only costs incurred by a maquila in Mexico. That is, Corp A has excluded from the computation of dutiable value all costs of the maquila that were actually paid by Corp A.

On a semiannual basis, Corp A prepares a detailed Customs Form 247 reporting the following information:

"1. The value of inventory (materials) sent from the U.S. to Mexico;

2. The cost of Mexican labor, materials, and overhead;

3. The value of assists furnished to the maquila by the U.S. manufacturer;

4. The value of assists furnished to the maquila by Corp A."

Under this arrangement, Corp A shifts to itself a number of the costs/expenses of a maquila and thereby allegedly reduces dutiable value of the imported property and increases its cost of goods sold deduction for U.S. tax purposes.

2. IRS Adjustments

The Internal Revenue Service has determined that Corp A has deducted on its U.S. Income Tax Return, Form 1120, certain expenses that are those of its maquilas. These deductions include accounting/legal expenses, automobile expense, telephone expense, depreciation, dues and subscription expenses, employee

benefits expenses, equipment rental expense, freight expense, general insurance expense, office supply expenses, outside services expenses, rent expense, supplies and tools expenses, repairs and maintenance expenses, taxes and licenses expenses, advertising expense, and entertainment and travel expenses. These expenses were not included on the Customs Forms 247 filed by Corp A and were not otherwise included in dutiable value. However, as described previously, the amount of Corp A's expenses incurred on behalf of a maquila were included in the price that it charged the U.S. manufacturer.

The IRS proposes to disallow deductions of or to allocate the expenses, paid by Corp A on behalf of a maquila, to the maquila. Authority for disallowance of the deductions is I.R.C. § 162; authority for allocation of the expenses from Corp A to a maquila is section 482.

Corp A argues that the expenses in issue were additional costs of goods sold that it paid for the products produced by a maquila and deductible as such. The IRS proposes to counter Corp A's argument with the position that under section 1059A, the expenses may not be added to Corp A's costs of goods sold, because the amounts were not included in dutiable value for customs purposes and, thus, may not be included in costs of goods sold or inventory basis.

Discussion

1. Background

I.R.C. § 1059A was enacted by section 1248 of the Tax Reform Act of 1986, P.L. 99-514. The Code section provides that a U.S. taxpayer that imports property into the U.S. in a transaction (directly or indirectly) from a person or persons related to the taxpayer, within the meaning of section 482, may not claim, for purposes of computing the basis or inventory cost of the property, a greater cost than the amount of the cost taken into account for customs valuation.

Section 1059A has a relatively narrow focus--that is, to prevent the federal government from being whipsawed by an importer, on property acquired from a related party, by claiming a low valuation for customs purposes and a higher valuation for tax purposes. Therefore, the section has no application to property not imported from a related party, not subject to any customs duty, or to property not subject to an ad valorem customs duty. Treas. Reg. § 1.1059A-1(c)(1). In this regard and for purposes of the section 1059A ceiling, the customs value may be increased by amounts which are not taken into account in determining the customs value, which are not property includible in customs

value, and which are appropriately included in the cost or inventory basis for income tax purposes. Treas. Reg. § 1.1059A-1(c)(2)(iv).

While Corp A contends that section 1059A does not apply to property imported from a foreign person who assembled the property (in contrast to a foreign manufacturer), under Customs regulation 152.103(a) described above, a transaction value is calculated for property imported from an assembler. Thus, just as much potential for whipsaw exists with respect to assembled property as with manufactured property. There is no reason to not apply section 1059A in both contexts. See E.C. McAfee v. United States, 842 F.2d 314 (Fed. Cir. 1988), which treats the transaction value of an assembler, calculated under Customs regulation 152.103(a)(3), as a sub-category of the regulation (152.103(a)(1)) dealing generally with computation of transaction value.

With respect to the meaning of the phrase "related party", section 1.1059A-1(a) of the Treasury Regulations states the following:

> "In the case of property imported into the United States in a transaction (directly or indirectly) by a controlled taxpayer from another member of a controlled group of taxpayers, except for the adjustments permitted by paragraph (c)(2) of this section, the amount of any costs taken into account in computing the basis or inventory cost of the property by the purchasing U.S. taxpayer and which costs are also taken into account in computing the valuation of the property for customs purposes may not, for purposes of the basis or inventory cost, be greater than the amount of the costs used in computing the customs value. For purposes of this section, the terms "controlled taxpayer" and "group of controlled taxpayers" shall have the meaning set forth in § 1.482-1(a)."

2. Issue 1

The question is whether Corp A, that does not take title to imported property, but is the importer of record for Customs' purposes, is subject to section 1059A. As previously pointed out, Corp A never takes title to the property imported from its maquilas, although it files the necessary customs forms and pays required duties. If the property is not imported directly or indirectly by Corp A, but is rather imported by the U.S. manufacturer that is unrelated to the maquila, section 1059A does not apply.

Corp A contends that section 1059A may not be applied to this case, because Corp A is not the importer of the products produced

by its maquilas. According to Corp A, the products produced by the maquilas are imported by the U.S. manufacturers, and because these manufacturers are not related to the maquilas, section 1059A is inapplicable. Corp A argues that it merely sells services to the U.S. manufacturers; that is, according to Corp A, it is selling the assembly services of its maquilas to unrelated U.S. manufacturing companies. Corp A contends that

> "[t]hese services include handling (i) the general administration of the assembly operation (maquiladora compliance, general facility maintenance, security system and procedures); (ii) the administrative and financial aspects of the assembly operation workforce (payroll preparations and implementations, fringe benefits for workforce, Mexican tax preparations); (iii) the import and export aspects of the assembly process (coordination of the flow of materials, components and products between the United States and Mexico); and (iv) the administration of the assembly work area (lease of assembly space and utility service)."

Further, Corp A states that it

> "(i) invests its own funds to locate, negotiate and contract with its United States customers, (ii) transports its customers' components, materials and supplies into Mexico, (iii) arranges for the lease of assembly facilities and the services of assembly workers to assemble customers' assembled products back into the United States through Mexican and United States customs."

While admitting that Corp A often acts as a buying agent for the U.S. manufacturer and arranges for the acquisition of certain materials used in the assembly process, Corp A argues that this service is provided merely

> "as a convenience for its customers and because Corp A has well-established contacts in Mexico for the acquisition of such supplies and for the disposition of the waste products created by the use of the supplies in the assembly process."

As previously pointed out, although Corp A does not take title to a product imported from a maquila, it claims a cost of goods sold deduction for the property on its federal income tax returns. That is, a maquila bills Corp A at the end of each month for the number of labor hours actually expended during the month. The amount of the bill is credited to the maquila's advance account (from which weekly advances had been made to the maquila) and debited to Account No. * * *. Account No. * * * represents Corp A's cost of goods sold account and serves as the basis for a cost of goods sold deduction on its income tax return. Thus, contrary

to Corp A's contention, it does in fact have a cost basis recorded on its books and claimed on its tax returns for articles imported from a maquila.

Although taxpayer does not have legal title to the imported products, it is entitled to a cost of goods sold deduction, as it claimed, provided the facts support the theory that taxpayer is the equitable owner of the property.

In American Motors Corp. v. Kenosha, 274 Wis. 315 (1957), aff'd per curiam 356 U.S. 21 (1958), the U.S. contracted with American Motors for the manufacture of aircraft engines. Under the contract, title to all parts, materials, tools, and work in process vested in the Government upon the making by the U.S. of any partial payment. The issue was whether the City of Kenosha could assess personal property tax on the aircraft engine inventory; and resolution of the question turned on whether American Motors or the U.S. owned the inventory. If the property was owned by the U.S., the tax could not be imposed by the City. In holding that the local tax could be imposed, the Wisconsin Supreme Court observed as follows:

> "In Offutt Housing Co. v. County of Sarpy, Neb., 1956, 351 U.S. 253, . . ., where the question was presented whether buildings erected by the corporation upon lands leased from the Government were taxable by the State of Nebraska, the United States supreme court stated:
>
> > Labeling the Government as the "owner" does not foreclose us from ascertaining the nature of the real interests created and so does not solve the problem. . . . The Government may have "title," but only a paper title. . . .
>
> Similarly, in Corliss v. Bowers, 1930, 281 U.S. 376, 377 . . .:
>
> > . . . taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed. . . ."

Whether a person has equitable ownership of property requires a factual examination, including the relationship between the parties and the way the parties deal with the property. Relevant factors include identification of the person that is liable for the costs of production (e.g., employee salaries, costs of materials, administrative costs, etc.); the person that bears the risk of loss should the property be damaged or destroyed; and the person that bears the risk of loss should the product not ultimately be sold.

The standard contract that Corp A enters into with its maquilas states that

> Corp A is an American corporation . . . and its main purpose is the production and sale of electronic articles.

Under the contract, the maquila agrees to accept components from Corp A and "to assemble them in conformity with the . . . instructions received from Corp A." (Clause 2) The contract requires the maquila to return all finished goods to Corp A (Clause 3) and states that

> "all the components for assembly sent by Corp A to . . . [the maquila] as well as the finished assembled product, <u>are and will remain the property of Corp A</u>." [Emphasis added.]"

(Clause 4). Furthermore, the contract requires Corp A to

> "insure against theft and fire all raw materials, components and assembled goods that might be at the facility [in Mexico] and/or in transit."

(Clause 7). The contract does not state that the property is being assembled for an unrelated third-party and does not mention such person by name in any context.

Other evidence indicating that Corp A is the equitable owner of the property imported from Mexico is that taxpayer is treated as the importer of the property for customs purposes. In this regard, Corp A exercises all incidents of ownership with respect to the importation process. As previously stated, the usual contract between Corp A and an unrelated manufacturer requires the former to file all required customs forms and to pay all duties. The contracts generally provide that Corp A will bear the economic burden of the duty imposed on the value of Mexican labor and that the unrelated manufacturer will bear the economic burden of the duty on material in the property that was not of U.S. origin.

Under these facts, it is our view that Corp A is the importer of the property and is subject to section 1059A.

3. Issue 2

Assuming that section 1059A applies to Corp A's importation of property from its maquilas, the next issue is the extent to which section 1059A limits Corp A's deduction of expenses it pays on behalf of a maquila.

As previously explained, the IRS contends that section 1059A bars Corp A from deducting expenses that it paid on behalf of a maquila. These expenses are listed above under IRS Adjustments and are expenses that a manufacturer would normally include in the cost basis of the product it produces.

Under 19 U.S.C. § 1401a(b)(1), dutiable (i.e., transaction) value of imported merchandise is defined generally as the amount paid or payable by the importer, plus packing costs, selling commissions paid by the buyer, the value of assists, any royalty or license fee paid by the importer as a condition of the sale of the imported merchandise, and the proceeds of any subsequent resale, disposal, or use of the imported merchandise that accrue, directly or indirectly, to the seller.

When considering the use of transaction value with regard to related-party transfer prices, as under the facts of the case for which you have requested technical advice, 19 U.S.C. § 1401(b)(2)(B) states that

> "[t]he transaction value between a related buyer and seller is acceptable . . . if an examination of the circumstances of the sale of the imported merchandise indicates that the relationship between such buyer and seller did not influence the price actually paid or payable; or if the transaction value of the imported merchandise closely approximates --
>
> * * *
>
> (ii) the deductive value or computed value for identical merchandise or similar merchandise. . . . [Emphasis added.]

19 U.S.C. § 1401a(e)(1) defines "computed value" as the sum of

> "(A) the cost or value of the materials and the fabrication and other processing of any kind employed in the production of the imported merchandise;
>
> (B) an amount for profit and general expenses equal to that usually reflected in sales of merchandise of the same class or kind as the imported merchandise that are made by the producers in the country of exportation for export to the United States;
>
> (C) any assist, if its value is not included under subparagraph (A) or (B); and
>
> (D) the packing costs."

As previously stated, the expenses in issue are paid directly by Corp A and do not show up on the books and records of a maquila. It is Customs' position that expenses that do not appear on the books of the foreign manufacturer are includible in dutiable value only if they quality as assists. In contrast, Customs will increase dutiable value by the amount of an expense that appears on the books of a foreign manufacturer, which was not included by the importer in dutiable value, and all or some of which expense is directly related to the manufacturing process.

With respect to whether the expenses in issue are assists, 19 U.S.C. $ 1401a(h)(1)(A) states that

> "[t]he term "assists" means any of the following if supplied directly or indirectly, and free of charge or a reduced cost, by the buyer of imported merchandise for use in connection with the production or the sale for export to the United States of the merchandise:
>
> (i) Materials, components, parts, and similar items incorporated in the imported merchandise.
>
> (ii) Tools, dies, molds, and similar items used in the production of the imported merchandise.
>
> (iii) Merchandise consumed in the production of the imported merchandise.
>
> (iv) Engineering, development, art work, design work and plans and sketches that are undertaken elsewhere than in the United States and are necessary for the production of the imported merchandise."

19 U.S.C. $ 1401a(h)(1)(B) lists three categories of items that do not come within the definition of "assist".

The question of whether an expense is an "assist" under customs law is substantially factual and involves interpretation of customs law and administrative rulings. None of the expenses listed in the IRS Adjustments section of this memorandum are attributable to materials, etc. incorporated into the imported merchandise (subparagraph (i) of the definition of "assist") or consumed in the production of the imported merchandise (subparagraph (iii) of the definition of "assist"). Nor do any of the items relate to engineering, art and design work (subparagraph (iv) of the definition of "assist").

However, Customs and the courts have treated the range of items included as assists as more expansive than the literal words of the statute might otherwise indicate.[3] For example, the issue in Texas Apparel Co. v. United States, 698 F. Supp. 932 (Ct. InT. Trade 1988), aff'd 883 F.2d 66 (Fed. Cir. 1989), cert. denied 110 S. Ct. 728 (1990), was whether the cost or value of sewing machines, including their repair parts and the cost of repairs, furnished to a foreign apparel manufacturer by the U.S. importer was includible in the transaction value of the imported clothing as assists. In concluding that the value of these items is includible in dutiable value as assists, the Court of International Trade, at page 936, approved the dichotomy that Customs draws between general purpose equipment and equipment directly related to a manufacturing process:

> "[T]he Customs Service has specifically interpreted the statute to include "general purpose equipment, such as sewing machines, ovens, drill presses, etc., . . . used abroad in the production of merchandise imported into the United States, [as] dutiable under section 401(h)(1)(A)(ii)." [Citation omitted.] On the other hand the Customs Service has held that "air-conditioning equipment, a power transformer, telephone switching equipment and emergency generators do not fall within the definition of assist, as they are not used in the production of the merchandise."

Customs has advised us that the following expenses are examples of items that are not assists:

"Rent on maquila's office equipment
Depreciation on auto owned by maquila
Landscaping
Janitorial Supplies
Office supplies for maquila
Business expenses of maquila
Maquila's electric bill
Safety/medical expenses of maquila
Maquila's telephone bill
Maquila's postage expenses
Removal of trash
Legal fees of maquila
Classified advertising of maquila
Executive development
Travel and entertainment expenses
Professional dues and subscriptions

[3]That is, 19 U.S.C. § 1401a(h)(1)(B)(ii) refers to "[t]ools, dies, molds, and similar items used in the production of the imported merchandise."

Charitable contributions
Consulting fees
Expenses attributable to conversion of currencies."

Examples of expenses that are directly related to the manufacturing process and, thus, are assists would be, in the case of imported apparel, the value of equipment necessary to perform the fabrication process and depreciation on this equipment, the expense of leasing manufacturing equipment, and the cost of repairing the manufacturing equipment (including parts).

Customs has also advised us that general, administrative, and overhead expenses are not assists. Since these expenses when paid by the importer do not appear on the books of the maquila, Customs has little authority to increase dutiable value by the amount of the expenses. This is true even though the U.S. importer is paying on the foreign manufacturer's behalf what are normally considered general, administrative, and overhead expenses, includible in a manufacturer's cost basis. However, if such expenses are reflected on the books and records of the foreign manufacturer, Customs may include in computed value an allocable portion of such expenses to the extent directly related to the manufacturing process * * *.

Conclusions:

Issue 1

It is our view that section 1059A applies to the cost basis that Corp A claims in the property imported from its related maquilas. If section 1059A does not apply to this situation, there would be a gap in its intended effect of eliminating the whipsaw caused by a taxpayer claiming an impermissibly low customs value and claiming a higher cost or inventory basis for tax purposes. The facts support an argument that Corp A is the equitable owner of the property in issue and as such is the importer of the property for tax purposes.

Issue 2

Section 1059A does not apply to an item that is not subject to an ad valorem customs duty. Therefore, the section 1059A ceiling may be increased by amounts which are not required to be included in customs value and which are properly included in cost or inventory basis for federal tax purposes. We have been advised by Customs that an expense of a foreign manufacturer that is paid by the U.S. importer and that does not appear on the books and records of the manufacturer is included in dutiable value only if the expense is an assist. Customs has also advised us that the

expenses in issue are not assists. Therefore, the section 1059A limitation may be increased by the amount of these expenses, and section 1059A will not support an adjustment.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) provides that it may not be used or cited as precedent.

IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

Form **5472** (Rev. July 1993)
Department of the Treasury Internal Revenue Service

Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business
(Under Sections 6038A and 6038C of the Internal Revenue Code)
For tax year of the reporting corporation beginning ...., 19 ......, and ending ...., 19 ......
Note: *Enter all information in the English language. Show money items in U.S. dollars.*

OMB No. 1545-0805
Expires 10-31-94

Part I — Reporting Corporation (See instructions.)

1a Name of reporting corporation
Number, street, and room or suite no. (If a P.O. box, see instructions)
City, state or province, ZIP or postal code, and country
1b Employer identification number
1c Total assets $
1d Principal business activity
1e Total value of gross payments made or received (see instructions) $
1f Total number of Forms 5472 filed for the tax year
1g Check here if this is a consolidated filing of Form 5472 . . . . ▶ ☐
1h Country of incorporation
1i Country(ies) under whose laws the reporting corporation files an income tax return as a resident
1j Principal country(ies) where business is conducted

Part II — 25% Foreign Shareholder (See instructions.)

1a Name and address of direct 25% foreign shareholder
1b U.S. identifying number, if any
1c Principal country(ies) where business is conducted
1d Country of citizenship, organization, or incorporation
1e Country(ies) under whose laws the direct 25% foreign shareholder files an income tax return as a resident

2a Name and address of direct 25% foreign shareholder
2b U.S. identifying number, if any
2c Principal country(ies) where business is conducted
2d Country of citizenship, organization, or incorporation
2e Country(ies) under whose laws the direct 25% foreign shareholder files an income tax return as a resident

3a Name and address of ultimate indirect 25% foreign shareholder
3b U.S. identifying number, if any
3c Principal country(ies) where business is conducted
3d Country of citizenship, organization, or incorporation
3e Country(ies) under whose laws the ultimate indirect 25% foreign shareholder files an income tax return as a resident

4a Name and address of ultimate indirect 25% foreign shareholder
4b U.S. identifying number, if any
4c Principal country(ies) where business is conducted
4d Country of citizenship, organization, or incorporation
4e Country(ies) under whose laws the ultimate indirect 25% foreign shareholder files an income tax return as a resident

Part III — Related Party
Check applicable box: Is the related party a ▶ ☐ foreign person or ▶ ☐ U.S. person?
All reporting corporations must complete this question and the rest of Part III.

1a Name and address of related party
1b U.S. identifying number, if any
1c Principal business activity
1d *Relationship—Check boxes that apply:* ☐ *Related to reporting corporation* ☐ *Related to 25% foreign shareholder* ☐ *25% foreign shareholder*
1e Principal country(ies) where business is conducted
1f Country(ies) under whose laws the related party files an income tax return as a resident

For Paperwork Reduction Act Notice, see page 2. Cat. No. 49987Y Form **5472** (Rev. 7-93)

Appendix IV
IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

Form 5472 (Rev. 7-93) Page 2

Part IV Monetary Transactions Between Reporting Corporations and Foreign Related Party
If reasonable estimates are used, check here ▶ ☐ . (See instructions.)

1	Sales of stock in trade (inventory)	1	
2	Sales of tangible property other than stock in trade	2	
3	Rents and royalties received (for other than intangible property rights)	3	
4	Sales, leases, licenses, etc., of intangible property rights (e.g., patents, trademarks, secret formulas)	4	
5	Consideration received for technical, managerial, engineering, construction, scientific, or like services	5	
6	Commissions received	6	
7	Amounts borrowed (see instructions) a Beginning balance ______ b Ending balance or monthly average ▶	7b	
8	Interest received	8	
9	Premiums received for insurance or reinsurance	9	
10	Other amounts received (see instructions)	10	
11	**Total.** Combine amounts on lines 1 through 10	11	
12	Purchases of stock in trade (inventory)	12	
13	Purchases of tangible property other than stock in trade	13	
14	Rents and royalties paid (for other than intangible property rights)	14	
15	Purchases, leases, licenses, etc., of intangible property rights (e.g., patents, trademarks, secret formulas)	15	
16	Consideration paid for technical, managerial, engineering, construction, scientific, or like services	16	
17	Commissions paid	17	
18	Amounts loaned (see instructions) a Beginning balance ______ b Ending balance or monthly average ▶	18b	
19	Interest paid	19	
20	Premiums paid for insurance or reinsurance	20	
21	Other amounts paid (see instructions)	21	
22	**Total.** Combine amounts on lines 12 through 21	22	

Part V Describe All Nonmonetary and Less-Than-Full Consideration Transactions Between the Reporting Corporation and the Foreign Related Party
(Attach separate sheet and check here ▶ ☐ .) (See instructions.)

Part VI Additional Information
All reporting corporations must complete Part VI.

1 Does the reporting corporation import goods from a foreign related party? ☐ Yes ☐ No

2a If "Yes," is the basis or inventory costs of the goods valued at greater than the customs value of the imported goods? ☐ Yes ☐ No
If "No," do not complete the rest of Part VI.

b If "Yes," attach a statement explaining the reason or reasons for such difference.

c If the answers to questions 1 and 2a are "Yes," were the documents used to support this treatment of the imported goods in existence and available in the United States at the time of filing Form 5472? ☐ Yes ☐ No

General Instructions

(References are to the Internal Revenue Code unless otherwise noted.)

Paperwork Reduction Act Notice.—We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping . . . . 17 hr., 13 min.
Learning about the law or the form . . . . . 1 hr., 41 min.
Preparing and sending the form to the IRS . . 2 hr., 3 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form more simple, we would be happy to hear from you. You can write to both the Internal Revenue Service and the Office of Management and Budget at the addresses listed in the instructions for the tax return with which this form is filed.

Purpose of form.—Use Form 5472 to provide information required under sections 6038A and 6038C whenever transactions occur between a reporting corporation and a foreign or domestic related party.

Who must file.—Generally, a reporting corporation must file Form 5472 if it had a reportable transaction with a foreign or domestic related party. For the meaning of reporting corporation, reportable transaction, and related party, see "Definitions" on page 3.

Exceptions to filing.—A reporting corporation is not required to file Form 5472 if:

1. It had no reportable transactions of the types listed in Parts IV and V of the form.

2. A U.S. person that controls the foreign related corporation files **Form 5471,** Information Return of U.S. Persons With Respect To Certain Foreign Corporations, for the tax year to report information under section 6038. To qualify for this exception, Form 5471 must contain information required by Regulations section 1.6038-2(f)(11) concerning the reportable transactions between the reporting corporation and the related party for the tax year.

3. The related corporation qualifies as a foreign sales corporation for the tax year and files **Form 1120-FSC,** U.S. Income Tax Return of a Foreign Sales Corporation.

4. It is a foreign corporation that does not have a permanent establishment in the United States under an applicable income tax treaty and timely files the notice required under section 6114.

5. It is a foreign corporation all of whose gross income is exempt from taxation under section 883 and it timely and fully complies with the reporting requirements of sections 883 and 887.

6. Both the reporting corporation and the related party are not U.S. persons as defined in section 7701(a)(30) and the transactions will not generate in any tax year gross income from sources within the United States or income effectively connected, or treated as effectively connected, with the conduct of a trade or business within the United States, and will

not generate in any tax year any expense, loss, or other deduction that is allocable or apportionable to such income.

Consolidated returns.—If a reporting corporation is a member of an affiliated group filing a consolidated income tax return, Regulations section 1.6038A-2 may be satisfied by filing a U.S. consolidated Form 5472. The common parent must attach to Form 5472, a schedule stating which members of the U.S. affiliated group are reporting corporations under section 6038A and which of those members are joining in the consolidated filing of Form 5472. The schedule must show the name, address, and employer identification number of each member who is including transactions on the consolidated Form 5472.

Note: *A member is not required to join in filing a consolidated Form 5472 just because the other members of the group choose to file one or more Forms 5472 on a consolidated basis.*

When and where to file.—File Form 5472 by the due date of the reporting corporation's income tax return (including extensions). A separate Form 5472 must be filed for each foreign or domestic related party with which the reporting corporation had a reportable transaction during the tax year. Attach Form 5472 to the income tax return and file a copy of Form 5472 with the Internal Revenue Service Center, Philadelphia, PA 19255. If the reporting corporation's income tax return is not filed when due, file a timely Form 5472 (with a copy to Philadelphia) separately with the service center where the tax return is due. When the tax return is filed, attach a copy of the previously filed Form 5472.

Definitions

Reporting corporation.—A reporting corporation is a 25% foreign-owned domestic corporation or a foreign corporation engaged in a trade or business within the United States.

Note: *Only reporting corporations that engage in reportable transactions during the tax year must file Form 5472.*

25% foreign-owned.—A corporation is 25% foreign-owned if it has at least one direct or indirect 25% foreign shareholder at any time during the tax year.

25% foreign shareholder.—Generally, a foreign person is a 25% foreign shareholder if the person owns directly or indirectly at least 25% of: **(a)** the total voting power of all classes of stock of the corporation entitled to vote, or **(b)** the total value of all classes of stock of the corporation.

When determining if a corporation is 25% foreign-owned, the constructive ownership rules of section 318 apply with certain modifications. Substitute "10%" for "50%" in section 318(a)(2)(C). Do not apply sections 318(a)(3)(A), (B), and (C) so as to consider a U.S. person as owning stock that is owned by a foreign person.

Related party.—The term "related party" means **(1)** any direct or indirect 25% foreign shareholder of the reporting corporation, **(2)** any person who is related (within the meaning of sections 267(b) or 707(b)(1)) to the reporting corporation, **(3)** any person who is related (within the meaning of sections 267(b) or 707(b)) to a 25% foreign shareholder of the reporting corporation, or **(4)** any other person who is related to the reporting corporation within the meaning of section 482 and the related regulations.

The term related party does not include any corporation filing a consolidated Federal income tax return with the reporting corporation.

The rules contained in section 318 apply to the definition of "related party" with the modifications listed under the definition of **"25% foreign shareholder,"** above.

Reportable transaction.—A reportable transaction is any type of transaction listed in Part IV of the form (for example, sales, rents, etc.), for which monetary consideration (including U.S. and foreign currency) was the sole consideration paid or received during the tax year of the reporting corporation or any transaction or group of transactions listed in Part IV of the form, if any part of the consideration paid or received was not monetary consideration or if less than full consideration was paid or received. Transactions with a U.S. related party, however, are not required to be specifically identified and valued in Parts IV and V.

Direct 25% foreign shareholder.—A foreign person is a direct 25% foreign shareholder if it owns directly at least 25% of the stock of the reporting corporation by vote or by value.

Ultimate indirect 25% foreign shareholder.—An ultimate indirect 25% foreign shareholder is a 25% foreign shareholder whose ownership of stock of the reporting corporation is not attributed (under the principles of section 958(a)(1) and (2)) to any other 25% foreign shareholder. See Rev. Proc. 91-55, 1991-2 C.B. 784.

Foreign person.—The term "foreign person" means an individual who is not a citizen or resident of the United States; an individual who is a citizen of a United States possession who is not otherwise a United States citizen or resident; any partnership, association, company, or corporation that is not created or organized in the United States; any foreign estate or foreign trust described in section 7701(a)(31); or any foreign government (or agency or instrumentality thereof) to the extent that a foreign government is engaged in the conduct of a commercial activity as defined under section 892. The term does not, however, include any foreign person who consents to file a joint income tax return.

Penalties

Penalties for failure to file Form 5472.—A penalty of $10,000 will be assessed on any reporting corporation that fails to file Form 5472 when due and in the manner prescribed. The penalty also applies for failure to maintain records as required by Regulations section 1.6038A-3.

Note: *Filing a substantially incomplete Form 5472 constitutes a failure to file Form 5472.*

If the failure continues for more than 90 days after notification by the IRS, an additional penalty of $10,000 will apply with respect to each related party for which a failure occurs for each 30-day period (or part of a 30-day period) during which the failure continues after the 90-day period ends.

Each member of a group of corporations filing a consolidated information return is a separate reporting corporation subject to a separate $10,000 penalty and each member is jointly and severally liable.

Criminal penalties under sections 7203, 7206, and 7207 may also apply for failure to submit information or for filing false or fraudulent information.

Record maintenance requirements.—A reporting corporation must keep the permanent books of accounts or records as required by section 6001 that are sufficient to establish the correctness of the Federal income tax return of the reporting corporation including information or records that might be relevant to determine the correct treatment of transactions with related parties. See Regulations section 1.6038A-3 for more detailed information. Also see Regulations section 1.6038A-1(h) and (i) for special rules that apply to small corporations and reporting corporations with related party transactions of de minimis value.

Specific Instructions

Part I

All filers must complete Part I.

Line 1a—Address.—Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the corporation has a P.O. box, show the P.O. box number instead of the street address.

Line 1c—Total assets.—Domestic reporting corporations enter the total assets from item D, page 1, Form 1120. Foreign reporting corporations enter the amount from line 15, column (d), Schedule L, Form 1120-F.

Line 1d—Principal business activity.—See the Instructions for Form 1120 or Form 1120-F for a list of principal business activities.

Appendix IV
IRS Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business

Form 5472 (Rev. 7-93) Page 4

Line 1e—Total value of gross payments made or received.—Enter on line 1e the total value in U.S. dollars of all foreign related party transactions reported in Part IV and Part V of this Form 5472. This is the total of the amounts entered on lines 11 and 22 of Part IV plus the fair market value of the nonmonetary and less-than-full consideration transactions reported in Part V. Do not complete line 1e if the reportable transaction is with a U.S. related party.

Line 1f.—File a separate Form 5472 for each foreign or each U.S. person who is a related party with which the reporting corporation had a reportable transaction. Enter the total number of Forms 5472 (including this one) being filed for the tax year.

Line 1j.—Provide the principal country(ies) where business is conducted. Do not include a country(ies) in which business is conducted solely through a subsidiary. Do not enter "Worldwide" instead of listing the country(ies). These rules also apply to lines 2c, 3c, 4c, Part II, and line 1e, Part III.

Part II

Only 25% foreign-owned U.S. corporations complete Part II.

The form provides sufficient space to report information on two direct 25% foreign shareholders and two ultimate indirect 25% foreign shareholders. If there are more than two direct foreign shareholders or more than two ultimate indirect 25% foreign shareholders, show the information called for in Part II on an attached sheet.

Report in lines 1a through 1e information about the direct 25% foreign shareholder who owns (by vote or value) the largest percentage of the stock of the U.S. reporting corporation.

Report in lines 2a through 2e information about the direct 25% foreign shareholder who owns (by vote or value) the second-largest percentage of the stock of the U.S. reporting corporation.

Report in lines 3a through 3e information about the ultimate indirect 25% foreign shareholder who owns (by vote or value) the largest percentage of the stock of the U.S. reporting corporation.

Report in lines 4a through 4e information about the ultimate indirect 25% foreign shareholder who owns (by vote or value) the second-largest percentage of the stock of the U.S. reporting corporation.

Lines 3a through 3e and lines 4a through 4e.—Attach an explanation of the attribution of ownership. See Rev. Proc. 91-55 and Regulations section 1.6038A-1(e).

Part III

All filers (foreign and domestic) must complete Part III, even if the related party has been identified in Part II as a 25% foreign shareholder. Report in Part III information about the related party with which the reporting corporation had reportable transactions during the tax year.

Part IV

Do not complete Part IV if the reportable transactions are with a domestic related party.

When completing Part IV or Part V, the terms "paid" and "received" include accrued payments and accrued receipts. State all amounts in U.S. dollars and attach a schedule showing the exchange rates used.

If the related party transactions occur between a related party and a partnership that is, in whole or in part, owned by a reporting corporation, the reporting corporation reports only the percentage of the value of the transaction(s) equal to the percentage of its partnership interest. This rule does not apply if the reporting corporation owns a less-than-25% interest in the partnership. The rules of attribution apply when determining the reporting corporation's percentage of partnership interest.

Generally, all reportable transactions between the reporting corporation and a related foreign party must be entered on Part IV.

Reasonable estimates.—When actual amounts are not determinable, enter reasonable estimates (see below) of the total dollar amount of each of the categories of transactions conducted between the reporting corporation and the related person in which monetary consideration (U.S. currency or foreign currency) was the sole consideration paid or received during the tax year of the reporting corporation.

A reasonable estimate is any amount reported on Form 5472 that is at least 75% but not more than 125% of the actual amount required to be reported.

Small amounts.—If any actual amount in a transaction or a series of transactions between a foreign related party and the reporting corporation does not exceed a total of $50,000, the amount may be reported as "$50,000 or less."

Line 7—Amounts borrowed.—Report amounts borrowed using either the outstanding balance method or the monthly average method. If the outstanding balance method is used, enter the beginning and ending outstanding balance for the tax year on lines 7a and 7b. If the monthly average method is used, skip line 7a and enter the monthly average for the tax year on line 7b.

Line 10—Other amounts received.—Enter on line 10 amounts received that are not specifically reported in lines 1 though 9. Include amounts in line 10 to the extent that these amounts are taken into account in determining the taxable income of the reporting corporation.

Line 18—Amounts loaned.—Report amounts loaned using either the outstanding balance method or the monthly average method. If the outstanding balance method is used, enter the beginning and ending outstanding balance for the tax year on lines 18a and 18b. If the monthly average method is used, skip line 18a and enter the monthly average for the tax year on line 18b.

Line 21—Other amounts paid.—Enter on line 21 amounts paid that are not specifically reported on lines 12 through 20. Include amounts in line 21 to the extent that these amounts are taken into account in determining the taxable income of the reporting corporation.

Part V

Do not attach the information required by Part V if the reportable transactions are with a domestic related party.

If the related party is a foreign person, the reporting corporation must attach a schedule describing each reportable transaction, or group of reportable transactions, listed in Part IV of the form. The description must include sufficient information so that the nature and approximate monetary value of the transaction or group of transactions can be determined. The schedule should include:

1. A description of all property (including monetary consideration), rights, or obligations transferred from the reporting corporation to the foreign related party and from the foreign related party to the reporting corporation;

2. A description of all services performed by the reporting corporation for the foreign related party and by the foreign related party for the reporting corporation; and

3. A reasonable estimate of the fair market value of all properties and services exchanged, if possible, or some other reasonable indicator of value.

If the entire consideration received for any transaction includes both tangible and intangible property and the consideration paid is solely monetary consideration, report the transaction in Part IV instead of Part V if the intangible property was related and incidental to the transfer of the tangible property (for example, a right to warranty services).

See the instructions for Part IV above for information on reasonable estimates and small amounts.

*U.S. Government Printing Office: 1993 — 343-034/80191

Option for Excluding From Transfer Price Certain Operating Expenses of Foreign Manufacturer Paid Directly by Importer Under Section 1059A

Sec. 1. LIMITATION ON COST OF PROPERTY IMPORTED FROM RELATED PERSONS

(a) IN GENERAL.— Section 1059A (related to basis or inventory cost in property imported from related persons) is amended by adding at the end thereof the following new paragraph:

"(c) REGULATIONS.— The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this section, including regulations allowing adjustments where customs pricing rules differ from appropriate tax valuation principles. Such regulations may not, however, allow adjustments for amounts paid directly or indirectly by the importer for operating expenses of the manufacturer which are not included in customs valuation.

The explanation of this provision in the report accompanying the legislation could provide a list of examples of what expenses should be considered operating expenses. The following is a list of examples.

1. Rent on foreign related party's office equipment
2. Depreciation on the foreign related party's auto
3. Landscaping
4. Janitorial supplies
5. Office supplies for the foreign related party
6. Business expenses for the foreign related party
7. Foreign related party's electric bill
8. Safety/medical expenses of the foreign related party
9. Foreign related party's telephone bill
10. Foreign related party's postage expenses
11. Removal of trash
12. Legal fees of the foreign related party
13. Classified advertising of foreign related party
14. Executive development
15. Travel and entertainment expenses
16. Professional dues and subscriptions
17. Charitable contributions
18. Consulting fees
19. Expenses attributable to conversion of currencies

Options for Including in Dutiable Value Certain Operating Expenses of Foreign Manufacturer Paid Directly by Importer

Option 1:

Sec. 1. CERTAIN EXPENSES TO BE INCLUDED IN DEFINITION OF "TRANSACTION VALUE"

(a) IN GENERAL.— Section 402(b)(1) of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (19 U.S.C. 1401a(b)), is amended by adding after subparagraph (E) the following new subparagraph:

"(F) any amounts for operating expenses paid directly or indirectly to the manufacturer by the importer as purchase price for the imported merchandise."

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (D) of section 402(b)(1) is amended by striking "and" at the end thereof.

(2) Subparagraph (E) of section 402(b)(1) is amended by striking "." and inserting ";and".

(3) Section 402(b)(1) is amended by striking "(A) through (E)" where it appears and inserting "(A) through (F)".

(c) EFFECTIVE DATE.— The amendment made by this section shall take effect upon enactment of this Act.

Sec. 1. CERTAIN EXPENSES TO BE INCLUDED IN DEFINITION OF "COMPUTED VALUE"

(a) IN GENERAL.—Section 402(e) of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (19 U.S.C. 1401a(e)(1)), is amended by adding after subparagraph (D) the following new subparagraph:

"(E) any amounts for operating expenses paid directly or indirectly to the manufacturer by the importer as purchase price for the imported merchandise."

(b) CONFORMING AMENDMENTS.—

(1) Subparagraph (C) of section 402(e) is amended by striking "and" at the end thereof.

(2) Subparagraph (D) of section 402(e) is amended by striking "." and inserting ";and".

(c) EFFECTIVE DATE.— The amendment made by this section shall take effect upon enactment of this Act.

Option 2:

Sec. 1. CERTAIN EXPENSES TO BE INCLUDED IN DEFINITION OF "ASSIST" IN DETERMINING TRANSACTION OR COMPUTED VALUE

(a) IN GENERAL.— Section 402(h)(1) of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (19 U.S.C. 1401a(h)(1), is amended by redesignating subparagraphs (B) and (C) as subparagraphs (C) and (D) and inserting after subparagraph (A) the following new subparagraph:

"(B) The term "assist" also includes any amounts for operating expenses paid directly or indirectly to the manufacturer by the importer as purchase price for the imported merchandise."

(b) EFFECTIVE DATE.— The amendments made by this section shall take effect upon enactment of this Act.

The explanation of the provision in the report accompanying the legislation could provide a list of examples of what expenses should be considered operating expenses. The following is a list of examples.

1. Rent on foreign related party's office equipment
2. Depreciation on the foreign related party's auto
3. Landscaping
4. Janitorial supplies
5. Office supplies for the foreign related party
6. Business expenses for the foreign related party
7. Foreign related party's electric bill
8. Safety/medical expenses of the foreign related party
9. Foreign related party's telephone bill
10. Foreign related party's postage expenses
11. Removal of trash
12. Legal fees of the foreign related party
13. Classified advertising of foreign related party
14. Executive development
15. Travel and entertainment expenses
16. Professional dues and subscriptions
17. Charitable contributions
18. Consulting fees
19. Expenses attributable to conversion of currencies

Maquiladora Case

In this appendix we develop a numerical illustration of two related parties—a U.S. parent company and its Mexican related party (maquiladora). The U.S. parent would purchase the foreign related party's goods and also pay a portion of the foreign related party's expenses. The model shows how the combined profits of both related parties increase when the U.S. parent makes payments on behalf of the foreign related party.

If the U.S. parent pays expenses on behalf of its foreign related party, it will pay less for the product itself when imported from the foreign related party. Because the product costs less, U.S. Customs duties will be less. However, the practice of paying foreign expenses may also result in higher overall income taxes because U.S. income taxes may be higher.

In the numerical illustration we assumed that (1) a U.S. parent had a Mexican maquiladora under a cost-plus contract that paid 5 percent of total cost; (2) total maquila expenses were $20 million, of which $10 million were duty-free and $10 million were dutiable expenses incurred in Mexico; (3) the U.S. parent was able to pay half of the amount of dutiable expenses ($5 million) on behalf of the maquiladora and deduct the same amount for U.S. tax purposes; (4) the maquiladora did not declare dividends; (5) the Mexican corporate income tax rate was 35 percent; (6) the top U.S. corporate income tax rate was 34 percent; and (7) the customs duty rate on the maquiladora's imports was 4 percent.[1]

The first assumption reflects the situation of a maquiladora that functions as a cost center, not as a profit center. While wage costs are lower in Mexico than in the United States, the Mexican corporate tax rate (35 percent) is greater than the top U.S. corporate tax rate (34 percent). Thus, the U.S. parent would not necessarily have an incentive to report a high level of taxable income in Mexico. The second assumption reflects the fact that many U.S. imports from the maquiladoras benefit from U.S. tariff provisions that allow manufacturers that assemble or process U.S. components abroad for reexport to the United States to pay duties only on that portion of the product's value that is added abroad, not on the product's final value.

Using the above figures, in table VII.1 we compared a baseline situation in which the parent and the maquiladora pay their respective expenses with a situation in which the U.S. parent pays half of the dutiable expenses

[1]The illustration does not represent a specific taxpayer. However, according to an IRS official, the assumptions used in this example reflect the characteristics raised in the IRS audits.

($5 million) of the maquiladora. Table VII.2 presents the detailed results of the baseline in which the two related parties pay for all their respective expenses. Table VII.3 presents the detailed results of the case in which the U.S. parent makes a $5 million payment on behalf of the maquiladora.

The results of our comparison show that when the parent pays half of the maquiladora's dutiable expenses, overall U.S. government revenues would decrease about 2 percent of the baseline's revenues; and the sum of the parent and the maquiladora's net incomes would increase by about 2.5 percent over the baseline's combined net income. The following are the specific revenue results shown in table VII.1:

U.S. government: U.S. revenues from customs duties would decline $210,000—from $440,000 to $230,000. This is because the value of the imports on which the duties are due dropped from $11 million to $5.75 million and customs duties are 4 percent of the value of dutiable imports.

Table VII.1: How Profits Increase and Government Revenues Decrease If U.S. Parent Pays $5 Million of Foreign Related Party's Expenses

	Baseline	U.S. parent pays $5 million	Change
U.S. government			
Duties	$440,000	$230,000	($210,000)
U.S. tax	2,570,400	2,726,800	156,400
Total U.S. revenues	3,010,400	2,956,800	(53,600)
Foreign government			
Foreign tax	350,000	262,500	(87,500)
Net income of two related parties			
U.S. parent	4,989,600	5,293,200	303,600
Foreign related party	650,000	487,500	(162,500)
Combined net income	5,639,600	5,780,700	141,100

Source: Tables VII.2 and VII.3.

The value of the imports fell because the U.S. parent's $5-million expense payment (and an accompanying 5-percent markup for the cost-plus foreign related party) were no longer included in the import value. See the customs duties listed in tables VII.2 and VII.3.

Partially offsetting decreased customs duties, U.S. tax revenues would rise by $156,400—from $2,570,400 to $2,726,800 as table VII.1 shows. This rise would result from the U.S. parent's income before taxes increasing from

$7.6 million on table VII.2 to about $8 million on table VII.3. U.S. income before taxes rose because customs duties went down as did the U.S. parent's overall payment to its foreign related party. The overall payment declined because the U.S. parent did not have to pay the 5-percent markup that would have gone with the $5-million payment if the payment were made directly to the foreign related party. Because the $156,400 in additional U.S. taxes was smaller than the $210,000 loss in customs duties, the U.S. government would lose net revenues of $53,600.

Table VII.2: Maquiladora's Baseline Case

	Foreign related party	U.S. parent	Combined results
Revenue	$21,000,000	$30,000,000	$30,000,000[a]
Cost of goods sold	20,000,000	21,000,000	20,000,000[a]
Other expenses	0	1,000,000	1,000,000
Payments made on behalf of foreign affiliate	0	0	0
Customs duties (4% x dutiable imports)[b]	0	440,000	440,000
Income before taxes	1,000,000	7,560,000	8,560,000
Taxes (35% in Mexico, 34% in the United States)	350,000	2,570,400	2,920,400
Net income	$650,000	$4,989,600	$5,639,600

[a]The combined results net out the intercompany transactions.

[b]Dutiable imports are equal to the value of imports ($21 million) minus the value of duty-free components ($10 million). Thus, dutiable imports are $11 million and duties are $440,000.

Source: GAO.

Foreign government: As shown in the foreign related party columns in tables VII.2 and VII.3, Mexico's tax revenues would decrease by $87,500—from $350,000 to $262,500. This decrease results from the foreign related party receiving less in direct payments, or revenue, from the U.S. parent.

Corporation: Corporate net profits (U.S. parent and maquiladora) would increase by $141,100—from $5,639,600 to $5,780,700.

An analysis of the financial statements in table VII.2 follows.

Foreign related party's results: Customs duties are determined by duty rates set by law and the dutiable value of imports. A portion of the value of goods imported into the U.S. may be duty-free if the final goods have incorporated some U.S.-made components. We assumed that the goods made in Mexico have incorporated $10 million worth of U.S.-made components, which would be exempt from duty. Thus, of the $20-million maquiladora expenses, $10 million were duty-free and $10 million were dutiable expenses incurred in Mexico.

The Mexican maquiladora operated under a cost-plus contract that provided a markup rate equal to 5 percent of total cost. Thus, the maquiladora's maximum revenues would be $21 million, which is the sum of cost of goods sold ($20 million) plus 5 percent of cost of goods sold ($1 million). The foreign tax rate was 35 percent; thus the maquiladora's tax payments and net income would be $350,000 and $650,000, respectively.

U.S. parent's results: The U.S. parent would import the full production of the maquiladora ($21 million), pay a U.S. Customs duty rate of 4 percent ($440,000), and incur additional expenses of $1 million in the United States. After subtracting all expenses from final sales to unrelated customers ($30 million), the U.S. parent's taxable income would be $7,560,000. The U.S. tax rate is 34 percent, so the U.S. parent's tax payments and net income would be $2,570,400 and $4,989,600, respectively.

Combined results: The combined results of the two related parties were obtained by adding up the revenues and expenses of the maquiladora and the U.S. parent and netting out the intercompany transactions. Specifically, the maquiladora's revenues ($21 million) would not be included in consolidated revenues, and the U.S. parent's imports ($21 million) would not be included in consolidated expenses.

Table VII.3 provides the figures that would result if the U.S. parent pays $5 million of the maquiladora's expenses. Our analysis of the changes in the financial statements follows the table.

Table VII.3: U.S. Parent Pays $5 Million of Foreign Related Party's Expenses

	Foreign related party	U.S. parent	Combined results
Revenue	$15,750,000	$30,000,000	$30,000,000[a]
Cost of goods sold	15,000,000	15,750,000	15,000,000[a]
Other expenses	0	1,000,000	1,000,000
Payments made on behalf of foreign related party	0	5,000,000	5,000,000
Customs duties (4% x dutiable imports)[b]	0	230,000	230,000
Income before taxes	750,000	8,020,000	8,770,000
Taxes (35% in Mexico, 34% in the United States)	262,500	2,726,800	2,989,300
Net income	$487,500	$5,293,200	$5,780,700

[a]The combined results net out the intercompany transactions.

[b]Dutiable imports are equal to the value of imports ($15.75 million) minus duty-free components ($10 million). Thus, dutiable imports are $5.75 million and duties are only $230,000.

Source: GAO.

Foreign related party's results: The U.S. parent would pay $5 million on behalf of the maquiladora. Thus, the maquiladora's expenses would be $15 million instead of $20 million. Because of this decrease in expenses, the maquiladora's revenues would also decrease because the maquiladora's revenues are tied to its costs.[2] The maquiladora's taxable income and Mexican taxes would decrease to $750,000 and $262,500, respectively.

U.S. parent's results: The U.S. parent's third-party sales would stay constant at $30 million, but its costs of goods sold would be lower than in the baseline case ($15.75 million compared to $21 million). However, the U.S. parent would be able to include its payment on behalf of the maquiladora ($5 million) as an additional deduction.

With respect to customs duties, the U.S. parent's $5 million payment on behalf of the maquiladora would reduce the maquiladora's dutiable components by $5 million plus the 5 percent profit markup ($250,000). As a result, customs duties would be reduced substantially to $230,000 from the $440,000 baseline amount.

[2]If the maquiladora's gross profits were not linked to its costs, the payment by the U.S. parent of a portion of the maquiladora's costs would result in higher foreign taxable income and higher foreign taxes.

Combined results: The combined results again net out the intercompany transactions. Although the foreign related party's costs of goods are $15 million instead of the baseline's $20 million, the U.S. parent would pay the other $5 million. This shift of expenses produces an additional combined net income of $141,100 (see table VII.1).

Comments From the Internal Revenue Service on Amending Section 1059A of the Code

Department of the Treasury

Office of
Chief Counsel
Internal Revenue Service
Branch 1
Associate Chief Counsel (International)
Room 3319
950 L'Enfant Plaza South, SW
Washington, DC 20024

CC:INTL-0593-91
Br1:WEWilliams

JAN 7 1993

Ms. Sheila K. Ratzenberger
Acting Assistant General Counsel
United States General Accounting Office

Dear Ms. Ratzenberger:

re: I.R.C. § 1059A

This responds to your memorandum dated December 4, 1992. Your memorandum explains that the General Accounting Office, at the request of Congressman J. J. Pickle, has reviewed the Internal Revenue Service's implementation of I.R.C. § 1059A. One of the objectives of your review is to study whether there are legislative options for eliminating differences in the rules for determining value for duty purposes and for determining cost or inventory basis for tax purposes, in order to further the purposes of section 1059A.

You refer to a Technical Advice Memorandum (TAM), dated July 10, 1992, that was prepared by this office. The TAM discussed application of section 1059A to certain transactions between a U.S. taxpayer and its wholly-owned Mexican subsidiary. The U.S. parent supplied its subsidiary with equipment and materials. Using the equipment and materials, the subsidiary assembled a product for sale to its parent. The sale price was the subsidiary's cost plus 5 percent of these costs. In addition, to cost plus 5 percent, the U.S. parent paid directly certain of the subsidiary's expenses, including administrative and overhead costs. The total of the amounts paid by the U.S. parent did not exceed an arm's length price.

For customs purposes, the U.S. taxpayer reported the subsidiary's cost plus 5 percent as dutiable value. That is, no duty was paid on the value of the expenses that the U.S. parent paid directly on behalf of its subsidiary. One of the issues in the TAM was whether section 1059A prevents the U.S. taxpayer from including the expenses that it paid directly in its cost or inventory basis in the property for tax purposes.

- 2 -

Customs advised us that the expenses paid directly by the U.S. taxpayer are not "assists" under 19 U.S.C. § 402(h)(1). Furthermore, Customs advised us that it has no authority to include in dutiable value a cost that does not appear on the books of the foreign manufacturer, other than assists. Because Customs' position is that the expenses are not dutiable, section 1059A may not be applied to prevent the expenses from being included in taxpayer's cost or inventory basis in the imported property for tax purposes. It is our view that the loophole is in customs law, not in the Internal Revenue Code.

At the request of the House Subcommittee on Oversight, you have drafted three alternative legislative proposals to correct the problem that prevents section 1059A from applying to the expenses in issue. Two of the alternatives involve amendments to customs law, and the third involves an amendment of I.R.C. § 1059A.

You ask that we respond to the following three questions:

1. <u>Are there currently any alternatives to section 1059A available to the Service to eliminate the problem addressed in the technical advice memorandum that do not require legislative action</u>?

The problem addressed in the TAM is not a tax problem; it is a problem with customs valuation resulting from a loophole in customs law.

In the cases that the IRS examined, the taxpayers originally claimed business deductions for the expenses that they paid on behalf of their subsidiaries. The law is clear that a taxpayer may not claim a deduction for the expense of another person, and the taxpayers in issue did not challenge disallowance of the deductions on this theory. Instead, taxpayers argued that the expenses they paid on behalf of the subsidiaries were a part of their cost of goods sold. As pointed out above, the facts will not support an argument by the IRS that the consideration paid by the U.S. importers, including the expenses paid on behalf of the subsidiaries, exceed an arm's length price. Therefore, the IRS may legitimately argue that the expenses are not deductible under section 162 and that the expenses may be reallocated from the U.S. taxpayer to the subsidiary under section 482. However, the IRS may not legitimately argue that the expenses are not a cost of goods sold.

In short, there is no underpayment of federal tax resulting from the problem discussed in the TAM. Therefore, we do not think that there is a solution to the problem in the Internal Revenue Code or Regulations.

2. What are the pros and cons of amending section 1059A in an attempt to eliminate the differences in valuation between IRS and Customs?

It is our view that the problem is with customs law and that the solution to the problem should be found under that law. An amendment to I.R.C. § 1059A will mean that the problem will not be solved in all cases, only when section 1059A applies to a transaction, i.e., related party transactions. Furthermore, if section 1059A is amended as proposed, taxpayers would have to overpay customs duties in order to avoid an income tax problem. Finally, customs laws and income tax laws seek to reach different concepts of valuation. For example, customs law excludes the value of U.S. content. Making the tax law more like the customs law would, therefore, lead to gross distortions of taxable income.

The third legislative alternative that you propose is to add a subsection (c) to section 1059A. The new subsection would authorize the IRS to publish regulations to carry out the "purposes" of the Code section

> including regulations allowing adjustments where customs pricing rules differ from appropriate tax valuation principles.

The proposed amendment to this extent is consistent with the legislative history of section 1059A. However, the proposed amendment would also state that

> [s]uch regulations may not, however, allow adjustments for amounts paid directly or indirectly by the importer for operating expenses of the manufacturer which are not included in customs valuation.

We object to this proposal on the same grounds set forth above. Under this proposal, all related parties obeying the customs laws would have a potential serious income tax problem. This was clearly not Congress' intent in enacting section 1059A. If, on the other hand, the customs laws or regulations are changed, the need to intentionally overpay customs duties to eliminate a potential tax problem will be eliminated.

3. Would amendment of Customs' valuation legislation be preferable? If so, would such an amendment violate GATT?

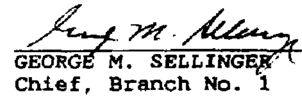
Since the problem encountered by the IRS in applying section 1059A is caused by customs law, we think that the problem should be solved under customs law, possibly by amending the definition of "transaction value" or the definition of "assist".

A determination of whether an amendment of customs law would violate GATT is beyond our expertise. You have advised us that you have referred this question to customs which seems to us to be the appropriate agency to answer the question. We think it is unfortunate, however, if GATT has caused customs law to be frozen in the state it was in on the date that GATT entered into effect.

If you have any further questions, please call Ed Williams at (202) 874-1490.

Sincerely,

ROBERT E. CULBERTSON
Associate Chief Counsel
(International)

By: 
GEORGE M. SELLINGER
Chief, Branch No. 1

Comments From the U.S. Customs Service on Amending Section 402 of the Customs Legislation

DEPARTMENT OF THE TREASURY
U.S. CUSTOMS SERVICE
WASHINGTON, D.C.

JAN 21 1992

CO:R:C:V
545171 VLB

Sheila K. Ratzenberger, Esquire
Acting Assistant General Counsel
United States General Accounting Office
Washington, D.C.

Dear Ms. Ratzenberger:

This is in response to your letter dated December 4, 1992, requesting a written opinion on three questions relating to the General Accounting Office (GAO) review of section 1059A of the Internal Revenue Code. Attached to your letter are two alternative proposals for amending 19 U.S.C. 1401a, the statute governing Customs appraisement of imported merchandise. In addition, you attached a proposal to amend section 1059A.

With these proposals in mind, you have proposed the following questions:

(1) Would amendment of the Customs legislation relating to dutiable value violate GATT?

(2) If such an amendment would not violate GATT, would Customs otherwise oppose such an amendment?

(3) Would amendment of section 1059A be preferable?

In responding to these questions, it is important to have some background on the system that U.S. Customs uses to appraise imported merchandise. The valuation system that is used by the United States as well as our major trading partners was negotiated during the Tokyo Round of multilateral negotiations within the General Agreement on Tariffs and Trade ("the GATT"). The valuation agreement is known as the Agreement on Implementation of Article VII of the General Agreement on Tariffs and Trade, or the Customs Valuation Code. The U.S. implemented the Customs Valuation Code into U.S. law through the Trade Agreements Act of 1979, which is now found in 19 U.S.C. 1401a.

The first proposal attached to your letter involves amending the definition of transaction value to include amounts for operating expenses paid to the manufacturer by the importer as purchase price for the imported merchandise. The term "transaction value" is specifically defined in Article 1 of the Customs Valuation Code as "the price actually paid or payable for

- 2 -

the goods when sold for export to the country of importation adjusted in accordance with the provisions of Article 8." The adjustments in Article 8 are for commissions, packing, "assists", royalties and license fees and proceeds of any subsequent resale disposal or use. Further, under Article 8.3, additions to the price actually paid or payable are made only under Article 8. These provisions were incorporated into U.S. law in 19 U.S.C. 1401a(b).

The above-referenced provisions of the Customs Valuation Code do not contain the language contained in the first proposed amendment. The amendatory language would have the effect of amending the U.S. definition of transaction value. In our opinion this would place the U.S. valuation legislation in conflict with the Customs Valuation Code.

This same issue arises with the second proposal, which is to amend 19 U.S.C. 1401a(h)(1) involving the definition of an "assist". Article 8.1(b) of the Customs Valuation Code lists items furnished free of charge or at a reduced cost by the importer that are to be added to the price actually paid or payable for the imported goods. In the U.S. legislation each item is defined as an "assist". The proposed amendment to the assist definition would place the U.S. in the position of adding items to the price actually paid or payable that are not additions under the Customs Valuation Code. Thus, the U.S. legislation would conflict with the Customs Valuation Code.

Your second question requests Customs position on the amendments if the proposals do not conflict with the Customs Valuation Code. However, as previously discussed, the proposed amendments would result in making the U.S. valuation legislation inconsistent with the Customs Valuation Code. Therefore, we have no comments on this question.

In your third question you ask whether an amendment to section 1059A would be preferable. Based on our analysis of the conflict that would be created if the Customs valuation legislation was amended, Customs would not oppose an effort to assist the Internal Revenue Service by amending section 1059A. Certainly, Customs would defer to the Internal Revenue Service to determine whether the proposed amendment will resolve the problems encountered by the Internal Revenue Service in applying section 1059A.

- 3 -

If you have any further questions on this issue, please contact either Tom Lobred or Virginia Brown in the Value and Marking Branch, Office of Regulations and Rulings (202) 482-7010.

Sincerely,

Samuel H. Banks
Assistant Commissioner
Office of Commercial Operations

Comments From the Office of the United States Trade Representative

OFFICE OF THE UNITED STATES
TRADE REPRESENTATIVE
EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON
20506

JUL 12 1993

Johnny C. Finch
Assistant Comptroller General
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

Thank you for providing us a copy of the draft report to the Congress on section 1059A of the Internal Revenue Code.

One of the options that GAO suggests is available to resolve the perceived inconsistency in the valuation definitions used by the U.S. Customs Service under section 402 of the Tariff Act of 1930 and the Internal Revenue Service under section 1059A is the multilateral renegotiation of the GATT Customs Valuation Code. See Draft Report at 20. Another option suggested in the draft report is to amend section 402 of the Tariff Act of 1930 either to include in the definition of the term "transaction value" those expenses paid on behalf of the foreign related party but not reflected in the customs value, or to include such expenses in the definition of the term "assist." See Draft Report at 21-22.

Now on page 11.

Now on page 11.

The Office of the United States Trade Representative ("USTR") shares the concerns expressed by the U.S. Customs Service and private sector representatives that our trading partners could argue that the legislative amendments described above would make section 402 inconsistent with the GATT Customs Valuation Code, which could result in a GATT challenge and possible retaliation by GATT Code signatories. See Draft Report at 4-5.

Now on page 3.

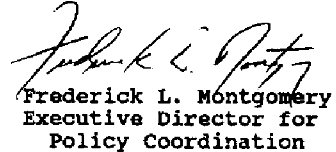
We also note that the Administration does not plan to renegotiate in the GATT Customs Valuation Code the treatment of expenses paid on behalf of a foreign related party within the context of the current Uruguay Round of multilateral trade negotiations. The Congress has recently provided an extension of the "fast track procedures" for Uruguay Round agreements if the President notifies the Congress, by December 15, 1993, of his intention to enter into an agreement or agreements. In light of this deadline and the President's announced desire to conclude the Uruguay Round expeditiously, it would not be feasible at this stage to introduce an issue of such complexity into the negotiations.

Johnny C. Finch
Page Two

Moreover, to the extent that the amendment to the Code suggested in the GAO draft report could result in higher duty payments by U.S. firms seeking to export goods to other Code signatories, it is not at all clear that such an amendment to the Code would be in the overall economic interest of the United States. It would appear that further study of the economic implications of the proposed Code revisions is necessary before the suggested course of action should be pursued in multilateral negotiations.

Thank you again for the opportunity to comment on the draft report. If you have any questions about our comments, please feel free to contact Barbara Norton, Director for GATT and Tariff Affairs, at (202) 395-5097, or Andrew Shoyer, Assistant General Counsel, at (202) 395-7203.

Sincerely,



Frederick L. Montgomery
Executive Director for
Policy Coordination

Comments From the U.S. Customs Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

THE COMMISSIONER OF CUSTOMS

WASHINGTON, D.C.

DATE: JUL 27 1993

FILE: VAL CO:R:C:V
545358 VLB

Johnny C. Finch
Assistant Comptroller General
General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

This is in response to your letter dated June 21, 1993, requesting the U.S. Customs Service comments on the draft report entitled "IRS' Administration of Tax-Customs Valuation Rules in Tax Code Section 1059A" ("the Report"). Thank you for the opportunity to comment.

As you know, the appraisement of importations between related parties is a complex undertaking, particularly in the area of maquiladora operations. As stated on pages 11 and 12 of the draft report, the preferred method of appraisement under section 402 of the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 ("the TAA"), is transaction value. Transaction value is defined as the "price actually paid or payable" for merchandise when sold for exportation to the United States, plus certain enumerated additions. See, section 402(b) of the of the TAA; 19 U.S.C. 1401a(b). The term "price actually paid or payable" is defined in section 402(b)(4)(a) of the TAA as "the total payment (whether direct or indirect . . .) made, or to be made, for imported merchandise by the buyer to, or for the benefit or, the seller (emphasis added)." If transaction value cannot be used, Customs must follow an established hierarchy of appraisement methods to determine the value of imported merchandise.

Now on page 7.

As discussed in the Report on page 12, one of the additions to the "price actually paid or payable" to arrive at transaction value, is the value of any "assists". Further, the following statements are found on page 12:

Now on page 7.

Now on page 7.

> [e]ssentially, according to IRS officials, the question raised by the IRS audits was what expenses qualified as assists in computing transaction value. Customs takes the position that expenses not appearing on the books and

- 2 -

> records of a foreign party, as was the case in the technical advice memorandum, are includible in dutiable value only if they qualify as assists ... The IRS audits, however, reflected a broader definition of what constitutes an assist.

Customs has two concerns about these statements. First, Customs is concerned that these statements may create confusion concerning whether transaction value is being used as the basis of appraisement or whether computed value (section 402(e) of the TAA) is being discussed. Second, Customs has been studying this issue in great detail and has preliminarily determined that many of the issues relating to appraisement that have been identified can be resolved administratively by Customs.

See comment 1.

The first issue, whether the basis of appraisement is transaction value or computed value arises from the above-quoted language because the first sentence references transaction value, but then the second sentence discusses expenses that are or are not carried on the books of a foreign party. As previously stated, the basis of transaction value is the price paid by purchaser of the imported merchandise. Customs adds the value of specified items to the price, such as assists, the physical items that were provided to the seller, to arrive at the transaction value. Under this method of appraisement, Customs does not use the books and records of either party to actually appraise the merchandise as the second sentence might imply. In other words, Customs does not add up all of the importer's booked expenses associated with the imported merchandise to arrive at a transaction value. Of course, Customs can require the purchaser to submit proof of payment of the declared price.

Conversely, if merchandise is being appraised under computed value, a cost of production methodology, Customs is required to use the figures appearing on the producer's books, unless the producer's figures are inconsistent with the amounts usually reflected in sales of merchandise of the same class or kind as the imported merchandise. See 19 U.S.C. 1401a(e)(2). Thus, it is under the computed value method of appraisement that the issue arises as to which expenses are carried on what set of books.

Finally, the last sentence of the quoted language is that "[t]he IRS audits, however, reflected a broader definition of what constitutes assists". As you know, the

- 3 -

See comment 2.

term "assist" is defined in section 402(h)(1)(A) of the TAA. Thus, it is unclear how IRS audit findings can create a broader definition of this term.

See comment 3.

In sum, Customs views the issue in a different manner than simply are the expenses assists. That is, the issue that has been raised by the finding of the IRS audits is can the payments, e.g., payments for office equipment rental fees, removal of trash and legal fees, that the U.S. firm is making on behalf of the maquiladora be included in the transaction value of the merchandise.

See comment 4.

With this formulation of the issue in mind, Customs has been reviewing the options presented in the draft report. One of the options that is discussed to resolve the inconsistency that you have identified is for the executive branch to attempt to renegotiate specified provisions of the Agreement to Implement Article VII of the General Agreement on Tariffs and Trade ("the Customs Valuation Code"). We would like to note that the current round of multilateral trade negotiations at the GATT, known as the "Uruguay Round", has been in progress for several years. Renegotiation of the Customs Valuation Code is not currently on the table. Moreover, the current text of the Uruguay Round agreements would require all countries to accede to the Customs Valuation Code as part of the creation of a Multilateral Trade Organization ("MTO"). Thus, it may be difficult for the United States to find an appropriate forum to raise the issue of renegotiating provisions of Customs Valuation Code. It is our understanding that the U.S. Trade Representative's Office has also expressed serious reservations concerning any movement to reopen negotiation of the Customs Valuation Code.

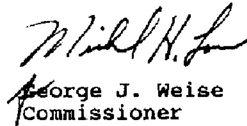
Clearly, at this point in time, Customs has no alternative but to follow the Customs Valuation Code and we believe that our interpretations are in compliance with international practice. Nevertheless, Customs is willing to pursue jointly with the IRS actual audits and legal reviews to determine whether we could bring the interpretations of the tax code and the valuation statute closer together. We would natually have to coordinate the

- 4 -

results and findings of these joint audits with USTR to determine what changes might be appropriate. If we decide that changes in interpretation are warranted, then we will likely have to publish the changes for public comment and, perhaps, allow a "grace" period for industry to alter current business arrangements.

Once again, thank you for the opportunity to comment on the draft report.

Sincerely,



George J. Weise
Commissioner

The following are GAO's comments on Customs' July 27, 1993, letter.

GAO Comments

1. We changed the report to delete the reference to books and records and to state that direct payments on behalf of related parties and the question of whether they were to be included in determining transaction value were the issues at hand.

2. We changed the report to state more clearly that IRS' approach reflected a broader concept of what should be included in transaction value.

3. The change made under comment 1 above addresses this concern.

4. The report notes disadvantages of this option on page 11 and in the characterization of USTR's comments on page 14.

Comments From the Internal Revenue Service

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

AUG - 9 1993

Mr. Johnny C. Finch
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

We appreciate the opportunity to review your draft report entitled "IRS' Administration of Tax-Customs Valuation Rules in Tax Code Section 1059A (Report)."

First, the Report mentions that the IRS and the Customs Service have discussed the difficulties surrounding the administration of IRC section 1059A due to differences in application of pricing and valuation methodologies. However, it gives little emphasis to the steps that both agencies have taken to establish and develop an on-going working relationship to deal with compliance and enforcement problems under section 1059A.

See comment 1.

For example, the Report does not mention that the agencies held a joint meeting concerning maquiladora operations and section 1059A early this year. As a result of this meeting, Customs indicated that certain expenses directly related to the manufacturing process, which are paid by U.S. parent companies on behalf of the foreign maquiladora entities, could possibly be considered dutiable items. Therefore, the IRS would be in a position to disallow the items as part of the cost of goods sold under section 1059A. If questionable items arise during a tax examination, a request may be made to Customs to provide a determination as to whether specific operating expense items could be dutiable in accordance with some allocation formula.

The IRS and the Customs Service have signed a formal working agreement providing for mutual assistance and the exchange of information between our agencies. Customs has been providing the IRS with information on imports which is useful to our field personnel in the development of transfer pricing issues under IRC section 482. This could be helpful if a potential section 1059A issue surfaces during an examination.

The agencies have also developed and implemented a formal charter for the IRS-Customs Policy Board during the latter part of 1992. The role of the Board is to identify issues to be commonly addressed, provide oversight and guidance for the formulation and development of major initiatives, formulate strategic plans on issues to be cooperatively undertaken, as well as to identify and address systematic barriers which impede cooperation between the IRS and the Customs Service.

See comment 2.

2

Second, the Report refers to the problem encountered by the IRS in certain maquiladora audits in which certain expenses of a Mexican manufacturer are paid directly by the U.S. importer. Because the expenses do not appear on the books of the Mexican corporation, they are not included in dutiable value for U.S. customs purposes.

In our letter to the GAO Acting Assistant General Counsel, dated January 7, 1993, which is included as Appendix VIII of the Report, the IRS examined the option of amending section 1059A. We think that the Report is misleading to the extent it implies that the problem in these cases may be solved through the use of section 162. In this letter, we noted that the IRS may not legitimately argue that the expenses are not a cost of goods sold and deductible as such under section 162. However, the IRS may legitimately argue that the expenses paid by the U.S. importer on behalf of a foreign subsidiary are not deductible under IRC section 162 and that the expenses may be reallocated from the U.S. taxpayer to the foreign subsidiary under section 482. The Report notes the IRS' view that the expenses are costs of goods sold and were the kind of items that were properly includible in cost basis for federal tax purposes. In other words, in the cases that we have seen, there has not been an underpayment of federal income tax. Any revenue loss to the Government in these transactions has been in customs duties.

Third, one of the legislative options that the Report discusses to solve the gap in customs law is an amendment to section 1059A. Specifically, the amendment would provide the IRS with the authority to disallow adjustments for amounts paid by an importer for operating expenses that are not reflected in the customs valuation. Thus, a taxpayer could not make adjustments to its cost basis for an expense that did not qualify as an "assist" under 19 U.S.C. sec. 1401a(h)(1)(A) and was not reflected in the duty value.

We think that the proposal to amend section 1059A to fix an obvious gap in customs law will have the result of forcing taxpayers to overpay their customs duties (under current law), or will result in denying a taxpayer a deduction for which it is clearly entitled to and require the taxpayer to overpay its income tax in order to compensate the Government for the perceived underpayment of customs duty. In our view, it is inappropriate to solve a customs problem through a change in the Internal Revenue Code. Rather, the problem should be solved by modifying the customs laws or regulations.

See comment 3.

3

Fourth, the Report discusses the possibility of amending customs law to require inclusion in dutiable value the expenses of the foreign manufacturer that are directly paid by the importer. Specifically, the Report discusses amending the definition of the term "transaction value" to include those expenses paid on behalf of the foreign related party but not reflected in the customs valuation. This change would not apply to imported merchandise that is appraised on the basis of deductive or computed value rather than transaction value.

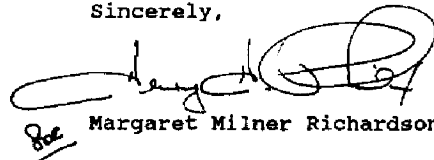
In all of the maquiladora cases, duty has been imposed on a computed value. Therefore, it is not clear how a change in the definition of "transaction value" under 19 U.S.C. section 1401a(b)(1) that will not apply to a computed value can solve the problem that the IRS has encountered.

The Report also suggests that the problem could be solved by amending the definition of "assist." The amendment would define assist to include the expenses of a foreign manufacturer that are paid directly by the U.S. importer.

The Report states that a change in the definition of the term assist would not apply to imported merchandise that is appraised on the basis of deductive value rather than transaction value. If this statement means, by implication, that a change to the definition of assist will apply to imported property appraised under the computed value method, the proposal should solve the problem encountered by the IRS in these cases.

We hope you find these comments useful.

Sincerely,



Margaret Milner Richardson

The following are GAO's comments on IRS' August 9, 1993, letter.

GAO Comments

1. In addition to the agency comments section describing IRS-Customs working relationships, we have added language on page 8 discussing IRS and Customs working together.

2. Because the relevant IRS district is no longer pursuing the use of section 162 in this context, we have deleted reference to it.

3. Although we do not agree that all of these cases used computed value, we do agree with the comments about the problems with changing definitions. Consequently, we have added the words "computed value" to the customs legislative option on page 11 and added a computed value section to appendix VI.

Comments From the Treasury Department

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

August 9, 1993

Mr. Johnny Finch
Assistant Comptroller General
General Accounting Office
Washington, D.C. 20548

Dear Mr. Finch:

Thank you for providing us with the opportunity to review the GAO draft report on section 1059A of the Internal Revenue Code. Our comments on the draft report are set forth below.

See comment 1.

First, you should note that several efforts are underway to improve coordination between the Internal Revenue Service and the Customs Service with respect to potential issues presented by Code section 1059A. I understand that these efforts are described in a separate letter to you from the Internal Revenue Service.

Second, the principal problem that is identified in the draft report is a practice of certain U.S. corporations with contract manufacturing "maquiladora" operations in Mexico to pay expenses on behalf of the maquiladora operation. (The draft report provides an example that illustrates this practice.) Since the U.S. company purchases substantially all the output of the maquiladora, the U.S. company effectively would deduct these expenses irrespective of whether it or the maquiladora incurred them. If the maquiladora pays the expenses, the U.S. company indirectly bears the expense for tax purposes, plus a mark-up over the cost, when it purchases the goods from the maquiladora and includes the purchase price in its cost basis or inventory. In the example, however, the U.S. company bears the expenses and deducts these amounts as costs of goods sold. The substantive difference between the two approaches is that the U.S. company pays less tax when the maquiladora pays the expenses, because in that case the U.S. company effectively bears the expense by including it in its cost basis or inventory, plus the mark-up that the maquiladora charges over its costs. Thus, as described in the example contained in the draft report, the U.S. company actually increases its U.S. income tax liability when it, rather than the maquiladora, defrays these expenses. According to the draft report, this increased income tax burden is more than offset by a reduction in customs duties, because the expenses that the U.S. company defrays are not dutiable under 19 U.S.C. section 1401(h)(1)(A).

Since the practice described in the report reduces customs duties and actually has the effect of increasing collections of income tax, we believe that the appropriate solution to the problem presented is to modify the customs rules with respect to the

definition of an "assist" that is dutiable under the customs laws. If expenses defrayed by the parent were encompassed by the definition of an assist, these expenses would be includable in the import value of the goods for customs purposes, and it would be possible to collect an appropriate amount of duty on such transactions.

An alternative solution set forth in the draft report is to attempt to solve the problem by amending section 1059A of the Internal Revenue Code. Under this approach the Internal Revenue Service would disallow adjustments for amounts paid by an importer for operating expenses that are not reflected in Customs valuation. Thus, a taxpayer could not make adjustments to cost basis or inventory for an expense that did not qualify as an assist and was not reflected in duty value. It is our view that the suggestion to prevent the evasion of customs duties through amendment of income tax provisions would result in the following consequences that are undesirable from a tax policy perspective.

This approach would have one of two results. The first possibility is that taxpayers will be obliged to pay more customs duty than is legally required if they wish to avail themselves of deductions for all the expenses that normally are deductible as costs of goods sold. In other words, they would be obliged to include in dutiable value the amount of any expenses that the U.S. company bore on behalf of the maquiladora in order to claim an appropriate amount of tax benefits for these expenses, despite the fact that U.S. law does not (and would not) include such expenses in dutiable value.

The second possibility is that, if a taxpayer does not include such expenses in dutiable value, deductions would be denied for expenses that otherwise are clearly deductible as costs of goods sold.

As a matter of tax policy, all expenses that are properly attributable to a trade or business should be deductible from income for purposes of calculating liability for income tax. Therefore the second possibility described above is unacceptable from a tax policy point of view, assuming, as appears to be the case, that the expenses at issue are properly attributable to a trade or business. The first possibility also is undesirable in that it effectively would require taxpayers to pay more duty than required by law in order to avail themselves of income tax deductions to which they should be entitled as a matter of sound tax policy.

Both of these undesirable possibilities are directly attributable to the fact that the proposal to amend section 1059A would attempt to remedy a flaw in the customs law through an amendment to the Internal Revenue Code. The problem that has been identified is a practice under which U.S. importers reduce their

2

customs duties. If, as appears to be the case, the intention of the proposal is to cause taxpayers to pay duty as if the expenses that the U.S. company incurs on behalf of the maquiladora were includable in dutiable value, the most logical and appropriate solution is to modify the relevant provisions of the customs law to so provide.

Thank you again for providing us with the opportunity to comment on the draft report.

Sincerely,

Leslie B. Samuels
Assistant Secretary
(Tax Policy)

3

The following are GAO's comments on Treasury's August 9, 1993, letter.

GAO Comments

1. We note this in our response to IRS comments.

Major Contributors to This Report

General Government Division, Washington, D.C.

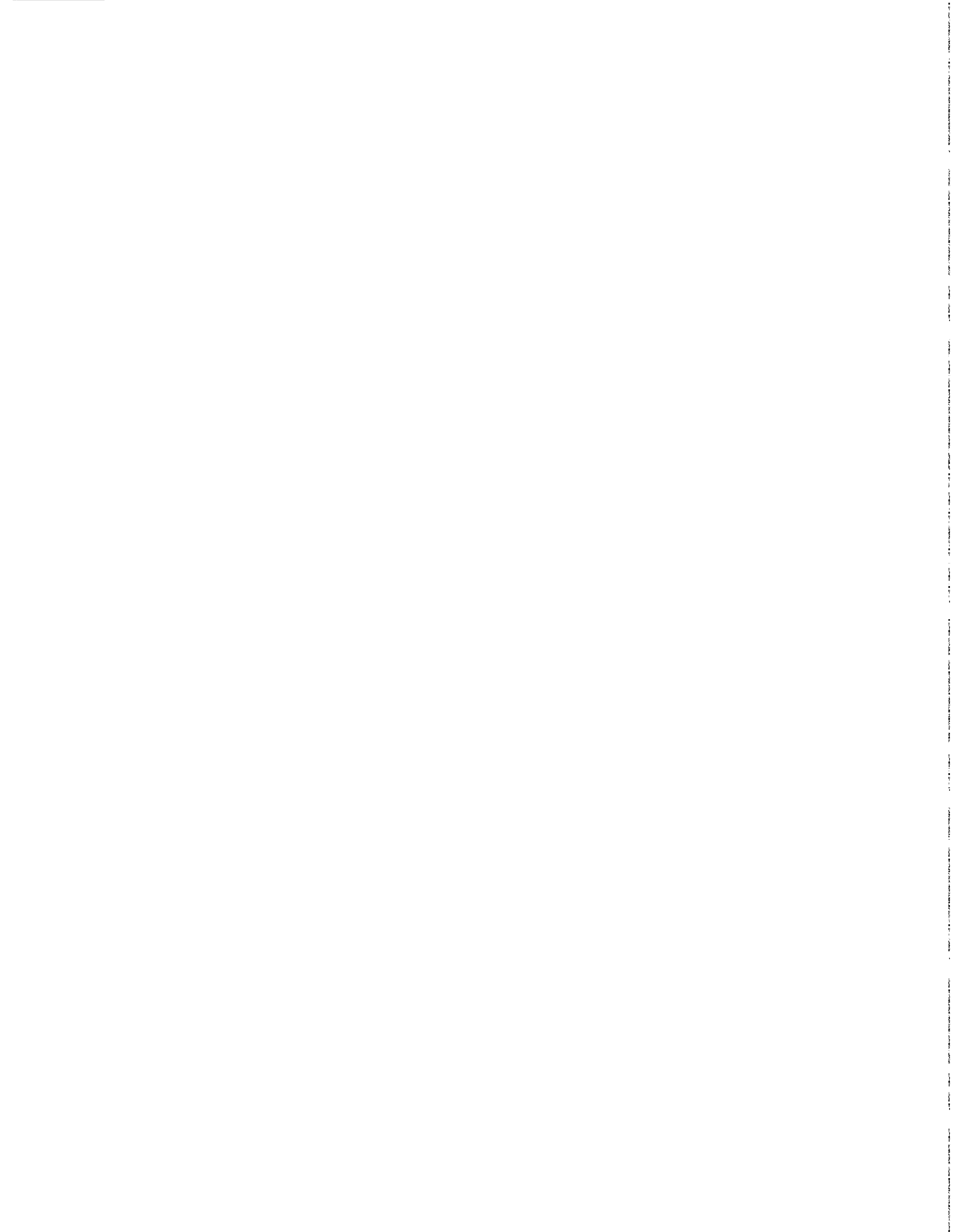
Jose R. Oyola, Assistant Director, Tax Policy and Administration Issues
Lawrence M. Korb, Assignment Manager

Office of General Counsel, Washington, D.C.

Rachel DeMarcus, Assistant General Counsel
Shirley A. Jones, Attorney-Advisor

Philadelphia Regional Office

Linda P. Schmeer, Site Senior
Christopher D. Morehouse, Evaluator
Douglas Sanner, Evaluator



Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015

or visit:

Room 1000
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC

Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066.

PRINTED ON RECYCLED PAPER

United States
General Accounting Office
Washington, D.C. 20548

Address Correction Requested