Transfer Pricing Thoughts: North America

By Patricia G. Lewis and Matthew W. Frank

Thoughts on Joint Ventures

We're delighted to have this space to share our thoughts on North American transfer pricing issues. Much of our time is spent wrestling with and resolving transfer pricing matters for both U.S. and foreign-based multinationals. While considerations of client confidentiality will preclude disclosing some of the more fascinating (and sometimes amusing and/or frustrating) aspects, we will no doubt find many things to talk about. Expect musings on issues that intrigue or perplex us, as well as practical perspectives and updates on developments.

A: *Joint Venture*

Q: *In what context might a third party not be a third party?*

From a transfer pricing standpoint, joint ventures are pesky things. They present tough threshold, factual and analytical problems, often involve large amounts of money and concomitantly large potential tax exposure, and just when you think you've got the tax angles all figured out (more or less), the business people tell you they can't implement any of your fixes because there's a third party involved.

Increasingly, intercompany business arrangements stray beyond the traditional wholly owned group, the conventional trigger for transfer pricing issues. Increasing globalization and scale, relentless competitive pressures and cost efficiency concerns, and the pace of technology evolution press taxpayers to combine forces, in one way or another, with totally unrelated parties–often, indeed, with their competitors. These ventures certainly *feel* arm's length – the terms are intensely and sometimes bitterly negotiated to be sure neither party gets an undue advantage–but are they arm's length for tax purposes? Are all or pieces of the venture subject to Internal Revenue Code Sec. 482 (or the equivalent in other countries) and, if so, are they vulnerable to attack and readjustment thereunder? If adjusted, how do you reestablish the desired equilibrium between the parties?

Joint ventures typically combine a number of different transactions. While the whole arrangement is negotiated at arm's length, separate pieces can have differing business or tax consequences to the parties, as the pieces straddle various tax borders and intersect different tax regimes. The balancing of the arrangement may take this into account intentionally or affect it as a result of other business considerations. Thus, although the best protection against transfer pricing adjustments in a joint venture is to ensure that each piece is independently defensible as an arm's-length result, this is often not feasible. One must, then, focus on the potential applicability of Code Sec. 482 in designing the joint venture or evaluating its tax consequences.[1]

The variations of joint venture situations and potential issues are endless. In the traditional joint venture where several parties variously contribute property, money, services and/or intangibles to a co-owned business enterprise, the contributions themselves, as well as any subsequent business dealings between any one of the venturers and the venture, are susceptible to transfer pricing issues. Contractual arrangements that fall short of a formal joint venture are also potentially vulnerable, *e.g.*, an agreement to co-market a product and share profits, though the likelihood of a non-arm's-length aspect is much lower due to the more single-minded nature of the transaction. Generally speaking, the need to focus on transfer pricing issues

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in ventures with unrelated parties increases with the number of moving parts.

Code Sec. 482, which applies only to transactions between two or more "controlled" taxpayers, does not have a crisp definition of control. It reaches "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose." *Moreover*, "[a] presumption of control arises if income or deductions have been arbitrarily shifted."[2] This broad definition confounds the desire for certainty and can readily sweep into its net 50/50 joint ventures as well as more or less top-heavy situations. There are several levels of inquiry: (1) Is there in fact "control" between the parties so that their transactions must be scrutinized under Code Sec. 482? (2) If there is such control, do the transactions nevertheless meet the arm's-length standard? (3) Even if there is no "control" in the first sense, are the transactions sufficiently "arbitrary" (assumedly meaning non-arm's-length) so that the parties are considered "controlled" for Code Sec. 482 purposes?

The case law is instructive, if not comprehensive. *B. Forman*[3] stands for the proposition that a 50/50 joint venture between unrelated parties can readily involve "control". The Court found the conclusion "inescapable" that two equal shareholders who made identical interest-free loans to their jointly-owned company acted in concert, so that interest should be imputed on the loans. The IRS shares this view,[4] and has memorialized it in the Code Sec. 482 regulations' reference to "acting in concert or with a common goal or purpose." Other case law is devoted to evaluating various characteristics pertinent to the "reality" of control, *e.g.*, power to appoint directors, liquidation preferences, contractual arrangements, family relationships, etc.

In *R.T. French Co.*,[5] the Tax Court took the pressure off the precise definition of control by honing in on issue (2) above – even if there is apparent "control," is it conceivable that there would be non-arm's length dealing? With respect to a royalty paid by a U.S. company to a foreign joint venture owned 51percent by the U.S. company's two British shareholders, the Tax Court noted that the substantial minority interest in the joint venture made it "unlikely" that the British companies would have paid an excessive royalty to the joint venture since 49percent would be diverted to a "stranger." A similar analysis was applied by the Tax Court in *Brittingham*[6], finding that it "strain[ed] all credulity" to think that income would be shifted from a 37-percent-owned company to a company in which that 37-percent owner had no ownership interest.

The case law is least well developed with respect to the third inquiry above – whether a plan to shift income demonstrates effective control – probably because its inherent circularity blurs the analysis. *See, e.g., Brittingham, supra*.

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What analytic process should be followed to work through the joint venture thicket?

Decide when to worry. The contours of a joint venture are not always obvious. If a taxpayer enters into a transaction with an entity/business in which it has an ownership interest or another contractual or *de facto* relationship, start worrying. Over 50-percent ownership clearly tags the transaction as controlled; consider other factors if there is lesser ownership. In particular, do not assume that a 50/50 joint venture is *per se* arm's-length; to the contrary.

Line up the pieces. Isolate all transactions with or within the arrangement in which the taxpayer participates.

Follow the money — and identify adverse interests. As to each transaction, trace the flow of funds and identify and evaluate the motivations of the various parties.

Determine whether compensating arrangements exist. If the parties have adverse interests as to one transaction – so that the transaction appears readily supportable as arm's-length – look to see if there are *other* transactions between the parties that might be asserted to be a *quid pro quo*. (This is the sophisticated version of the *B. Forman* "acting in concert" concept.)

Ask "The Question." Test yourself with the IRS's question: Would the transaction be done this way if there were no ownership-type relationship with the other party? If not, why are you doing it? And see if there is a non-tax-driven answer.

Combine problematic segments. If each transaction cannot be independently defended under Code Sec. 482, see if various pieces can be packaged to

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demonstrate adverse interests and net overall balanced tax results.

Document, document. Record the arm's-length negotiations and considerations of the parties. Memorialize the factual and legal analysis of the JV arrangement and explain why it *feels* like arm's-length arm twisting.

Obtain professional analysis. Absent facile answers to some of the above questions, it may be necessary to obtain independent economic and legal analysis of the arm's-length nature of key parts or the whole. In appropriate cases, it may make sense to obtain a legal opinion regarding lack of control, to minimize the risk of penalties under Code Sec. 6662(e).

Consider risk-bearing exposure and adjustments. You may want to consider ways to right the balance between the parties in the event transfer pricing adjustments are imposed; this exercise can be quite complex and generates tax consequences of its own.

Be sensitive to tables-turned considerations. Keep in mind the fact that the bi-directional nature of Code Sec. 482 suggests the practical wisdom of even-handed administration (*e.g.*, inbound vs. outbound, favorable fact pattern vs. unfavorable fact pattern), and watch for potential results-orientation of the IRS. Honing in on the converse case may form the groundwork for persuasive arguments against IRS overreaching. A recent case illustrates this conundrum. In *National Semiconductor,*[7] transactions with a 4-percent-owned venture were held not suitable as Comparable Uncontrolled Transactions ("CUPs"). The *IRS* had argued that these were CUPs, based on *R.T. French*, but the Tax Court held to the contrary. The opinion raised an interesting question regarding the burden of proof as to "control" (suggesting the IRS should have provided evidence of an absence of control), although the court later attempted to defuse this issue when denying the IRS's motion for reconsideration.

Identify the risks. It will seldom be possible to satisfactorily address all of the above points in a complex joint venture. Business considerations must be balanced – and tend to prevail because of the business context – but the parties should at least be aware of any tax risks and enter the transaction with their Code Sec. 482 eyes open.

Standing back, 50/50 joint venturers ought to be the quintessential arm's-length negotiators. Focusing on the separate parts of the venture early in the planning stage can help preserve that character for transfer-pricing purposes.

ENDNOTES

1 Joint ventures present many domestic and international tax issues apart from Code Sec. 482, which are beyond the scope of this column.

2 Reg. § 1.482-1(i)(4).

3 *B. Forman & Co., Inc.*, CA-2, 72-1 USTC ¶9182, 453 F.2d 1144, *cert. den*. 407 US 934, *rev'g* Dec. 30,087, 54 TC 912.

4 *See* Rev. Rul. 65-142, 1965-1 CB 223 (explaining the IRS's withdrawal of its prior acquiescence in the early Tax Court case *Lake Erie and Pittsburgh Ry. Co.,* 5 TC 558 (acq.) (1945), 1945 CB 5, 1965-2 CB 7 (Nonacq.) (rent-free use of railroad property by two equal shareholders)). The Tax Court in *Lake Erie*, followed in the lower Tax Court proceedings in *Forman,* had found Code Sec. 482 inapplicable because neither shareholder individually controlled the corporation.

5 *R.T. French Co.*, Dec. 32,119, 60 TC 836.

6 *Brittingham*, Dec. 33,856, 66 TC 373, *aff'd per curiam*, CA-5, 79-2 USTC ¶9499, 598 F.2d 1375, *See also* companion case, *Dallas Ceramic Co.*, 598 F.2d 1382, *rev'g and rem'g,* CA-5, 74-2 USTC ¶ 9500.

7 *National Semiconductor Corp.*, 67 TCM 2849, 2872.