



BACKGROUND PAPER #13

Does the Transfer Pricing Penalty Violate the Fourth Amendment to the Constitution?

December 1994

By J. Dwight Evans, Esq.
Special Tax Counsel
Tax Foundation

About the Tax Foundation

As the size of government continues to grow, so too does the need for reliable information about its cost and scope. Since 1937, the Tax Foundation has been monitoring tax and fiscal activities at all levels of government: federal, state and local. In that year, civic-minded businessmen envisioned an independent group of researchers who, by gathering data and publishing information on the public sector in an objective, unbiased fashion, could counsel government, industry and the citizenry on public finance.

More than 50 years later, in a radically different public arena, the Foundation continues to fulfill the mission set out by its founders. Through newspapers, radio, television, and mass distribution of its own publications, the Foundation supplies objective fiscal information and analysis to policymakers, business leaders, and the general public.

The Tax Foundation's research record has made it an oft-quoted source in Washington and state capitals, not as the voice of left or right, not as the voice of an industry or even of business in general, but as an advocate of a principled approach to tax policy, based on years of professional research.

Today, farsighted individuals, businesses, and charitable foundations still understand the need for sound information on fiscal policy. As a nonprofit, tax exempt 501(c)(3) organization, the Tax Foundation relies solely on their voluntary contributions for its support.

About the Author

J. Dwight Evans, Esq., served as a tax attorney for Mobil Corporation for 29 years, most recently as Assistant General Tax Counsel. He retired from Mobil in 1993, and now serves as Special Tax Counsel for the Tax Foundation.

BACKGROUND PAPER #13

Does the Transfer Pricing Penalty Violate the Fourth Amendment to the Constitution?

December 1994

By J. Dwight Evans, Esq.
Special Tax Counsel
Tax Foundation

©1994 Tax Foundation. All rights reserved.

* * *

Tax Foundation
1250 H Street, N.W.
Suite 750
Washington, DC 20005
202-783-2760

Table of Contents

Introduction	1
Section 482 Transfer Pricing	1
The Fourth Amendment Protection	2
The Transfer Pricing Document Production Scheme	3
The Scope of the Fourth Amendment Protection Against an Administrative Search	4
A. Is there a governmental search?	5
B. Is the governmental search reasonable?	7
Does an IRS Request for Transfer Pricing Documents Constitute an Administrative Search?	8
Does an IRS Request for Transfer Pricing Documents Involve an Unreasonable Search?	10
Steps Which Can Be Taken to Eliminate or Reduce the Fourth Amendment Concerns	11
Conclusion	12

The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized. U.S. Constitution, Amendment 4.

Introduction

The U.S. Treasury has recently issued temporary regulations implementing a new regime of tax penalties relating to transfer prices. The redesigned penalties in Section 6662 (e) and (h) of the Internal Revenue Code (Code) are imposed on taxpayers who substantially understate taxable income as a result of misvaluation of the intercompany transfer prices used in their tax return. The new penalties are accompanied by temporary regulations relating in part to the supporting documents which taxpayers are required to have in hand when they file their tax returns and which, in order to avoid tax penalty, they must provide to the Internal Revenue Service (IRS) within 30 days of a "request" for such transfer pricing documentation.

Tax penalties are an important tool of tax administration. It has long been recognized, however, and the 1989 Report on Civil Tax Penalties for the Internal Revenue Service Commissioner (Commissioner's Study) reaffirmed, that if a tax penalty is to be effective it must be perceived by taxpayers as being fairly and reasonably applied. The new Section 482 net adjustment penalties, particularly the rules requiring the creation and maintenance of supporting transfer pricing documents, and, specifically, the requirement that those documents be produced for IRS inspection at its request, raise questions whether these rules, as presently written, violate Fourth Amendment protections in the U.S. Consti-

tution against unreasonable searches and seizures. Because the regulations have been issued in temporary form, it would be relatively easy for the IRS to address any Fourth Amendment difficulties before the regulations are issued in final form.

Section 482 Transfer Pricing

Section 482 of the Code, and in particular its extensive regulations, require corporate taxpayers which are related to each other by common ownership to use arm's length prices for U.S. income tax purposes in transactions with each other. This simply means that the price set in a transaction between related parties should be the same as that which would be charged between unrelated parties engaged in a similar transaction.

The arm's length standard is the international standard for determining intercompany transfer prices for goods and services crossing international borders. Because of the high degree of legal and factual complexity in determining transfer prices in international trade, the IRS sees in these transactions many opportunities for related taxpayers to arrange their international operations in non-economic ways so as to minimize income taxes, especially U.S. taxes. For example, consider a profitable U.S. parent company which owns a subsidiary operating at a loss in the U.K. The U.S. parent company also has excess foreign tax credits for U.S. tax purposes. Such a corporation can reduce its overall tax liability by shifting income from the U.S. to the U.K. This objective can be obtained by charging less than an arm's length price on goods sold or services provided by the U.S. parent to its U.K. subsidiary. In this way, the U.S. parent records less income and pays less U.S. tax, while the U.K. subsidiary is

able to buy goods and services from its parent company at a low price and realize a profit in the U.K. Because of the losses previously generated in the U.K., this profit is not taxed or is taxed at a relatively low rate.

The IRS and Treasury are legitimately concerned about the potential loss of U.S. tax revenue from the misstatement of value in transfer pricing between related parties. Beginning in 1988 with the Treasury's so-called Intercompany Pricing White Paper (White Paper) and continuing with Congress' deliberations in enacting both the 1990 and 1993 tax bills, the IRS has increasingly argued that the solution to the loss of tax revenue caused by alleged multinational taxpayer misvaluations in intercompany transfer pricing is the development of a new tax penalty regime specifically designed to force taxpayers to (1) create and maintain transfer pricing documents and records demonstrating compliance with the arm's length standard contemporaneous with the filing of the tax return, and (2) produce such documentation for government inspection within 30 days of an IRS request.

The Fourth Amendment Protection

The Fourth Amendment in its origin is closely connected to problems associated with enforcement of tax laws. The prohibition against unreasonable searches and seizures stems in very large part from the American colonists' adverse experience with the enforcement of British excise taxes. American merchants and businessmen objected strenuously to the sweeping powers granted the King's tax officials under general warrants and writs of assistance to require the involuntary production of commercial goods, docu-

ments, and records in the conduct of searches for evidence of tax evasion. As stated by Justice Blackmun in the U.S. Supreme Court's decision in G.M. Leasing Corp. v. United States, 429 U.S. 338, 355 (1977):

"Indeed, one of the primary evils intended to be eliminated by the Fourth Amendment was the massive intrusion on privacy undertaken in the collection of taxes pursuant to general warrants and writs of assistance."

Consequently, it is not surprising that the Supreme Court has held that a businessman has a constitutional right under the Fourth Amendment to conduct business free from unreasonable intrusions upon his private commercial property by government tax agents. In G.M. Leasing Corp., involving a warrantless entry by IRS agents into a business office and the seizure of business documents as a part of a levy under Section 6331 (b) of the Code for the collection of income taxes, the federal government argued that the history of the English common law and the laws in several states prior to the adoption of the Bill of Rights supports the view that the Fourth Amendment "... was not intended to cover intrusions into privacy in the enforcement of the tax laws." This contention was summarily rejected by the Court, with Justice Blackmun stating (355):

"We do not find in the cited materials anything approaching the clear evidence that would be required to create so great an exception to the Fourth Amendment's protection against warrantless intrusions into privacy."

It is equally clear, however, that the constitutional right to commercial privacy is not absolute. The businessman's interest in maintaining privacy for his commer-

cial property, including documents and records, must be balanced against the government's interests and needs in connection with its law enforcement duties, including its duty to enforce tax laws. The Fourth Amendment protects against unreasonable intrusions by agents of the government, but does not prohibit reasonable intrusions. The privacy interest in commercial property, including business books and records, may, in certain circumstances, be adequately protected by regulatory schemes authorizing warrantless inspections. [See Donovan v. Dewey, 452 U.S. 594, 598-599 (1981).] Corporations do not have an unqualified right to conduct their affairs in secret, and can not claim equality with individuals in the enjoyment of the right to privacy. [United States v. Morton Salt Co., 338 U.S. 632, 652 (1950)]

The Transfer Pricing Document Production Scheme

Neither Congress in enacting the transfer pricing penalty, nor the IRS in publishing temporary regulations, appears to have considered whether the document production requirements of the transfer pricing penalty violate Fourth Amendment protections. Section 6662 (e) and (h) of the Code impose a transfer pricing valuation misstatement penalty of 20%, and in some cases 40%, of a taxpayer's net Section 482 transfer price adjustment, i.e., the net increase in taxable income for a year resulting from allocations under Section 482 (the allocation of income and expenses between related parties) as finally determined for tax purposes. For example, if a taxpayer's net transfer pricing adjustment is as little as \$5 million, a 20% penalty in the amount of \$1 million may apply. If the net adjustment is as much as \$20 million, the taxpayer may be subjected to the

higher 40% penalty amounting to \$8 million. Section 6662 (e)(3)(B) of the Code provides that a taxpayer can avoid this penalty if the taxpayer establishes that (1) it determined its transfer price using a method authorized by the Section 482 regulations (a specified method) and the use of such method was reasonable or, where such a method is not likely to result in a price clearly reflecting income, using another method which would clearly reflect income (an unspecified method); (2) the taxpayer has documentation in existence at the time that it filed its tax return which sets forth how the transfer price was determined and establishes the reasonableness of the price; and, (3) the taxpayer provides that documentation to the Secretary of the Treasury (i.e., IRS) within 30 days of a request for such documentation.

The Transfer Pricing Penalty Temporary Regulations (Section 1.6662-6T) amplify the statute's provisions. Under the temporary regulations taxpayers are now required to have available and produce within 30 days of an IRS request two new categories of documents applicable under both the specified and unspecified transfer pricing methods, namely, "principal" documents and "background" documents. Principal documents are those necessary to establish that the taxpayer has correctly used the specified or unspecified transfer pricing method. The temporary regulations specify that principal documents must include the following:

(1) An overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;

(2) A description of the taxpayer's organizational structure (including an organization chart) covering all related parties engaged in transactions potentially relevant under Section 482, including for-

oreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the United States;

(3) Any documentation explicitly required by the regulations under Section 482;

(4) A description of the method selected and an explanation of why that method was selected;

(5) A description of the alternative methods that were considered and an explanation of why they were not selected;

(6) A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions;

(7) A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;

(8) An explanation of the economic analysis and projections relied upon in developing the method; and,

(9) A general index of the principal and background documents and a description of the recordkeeping system used for cataloging and accessing those documents.

The background documents are not described in the temporary regulations in detail but are stated to be the taxpayer's documents that support the assumptions, conclusions, and positions contained in the principal documents. This includes, in some circumstances, documents listed in Treasury Regulation Section 1.6038A-3(c) (records to be maintained by foreign-owned U.S. corporations and foreign corporations engaged in business in the U.S.). In many cases, if not most, the background documents will be voluminous.

Beginning with the White Paper, it is clear from the legislative history of Section 6662 that the section is intended by Congress and the IRS to correct an audit problem, namely, the alleged failure by

many taxpayers to produce and make available their transfer pricing records and documents for IRS inspection in the conduct of a transfer pricing audit. As a result of the Section 6662 (e) and (h) penalty regime, the IRS is now in position to compel taxpayers to produce at the IRS audit both principal documents and background documents. Because of the voluminous nature of these documents, particularly the background documents, it is not unlikely that IRS auditors will want transfer pricing documents and records to be either delivered to them at their offices or be available for inspection at the taxpayer's premises.

Neither Section 6662 nor the temporary regulations specify who in the IRS is to make the request for either principal or background documents, when, how frequently, or under what circumstances that request is to be made, how it is to be made, or how the examination of documents is to be conducted. No mention is made in either the statute or regulations of the need for an IRS administrative summons in making a request for a taxpayer's transfer pricing documents. In both the statute and temporary regulations, these matters are left to the discretion of IRS personnel.

The Scope of the Fourth Amendment Protection Against an Administrative Search

In making the determination whether governmental action to inspect or require the production of business books and records violates the Fourth Amendment's protection, there is a threshold question whether the governmental administrative action constitutes a search or seizure of property and, if so, whether or not the search or seizure is reasonable under

Fourth Amendment limitations.

(A) Is there a governmental search?

For Fourth Amendment protections to apply there must be a governmental search or seizure of property. It is clear that Congress can constitutionally require a business to compile large volumes of information, keep extensive records regarding its business activities and make reports based on all or part of this information to a federal regulatory agency. (See, for example, the Sections 6038 and 6038A information and reporting requirements with respect to certain foreign owned corporations.)

In the case of The California Bankers Ass'n v. Shultz, 416 U.S. 21 (1974), provisions of the Bank Secrecy Act requiring financial institutions to keep extensive records regarding their banking activities and file reports with the Secretary of the Treasury were challenged as violating the Fourth Amendment's protection against unreasonable searches and seizures. In denying this contention, and in upholding the constitutionality of the Bank Secrecy Act's recordkeeping and reporting requirements, the U.S. Supreme Court drew clear distinctions between recordkeeping and reporting requirements on the one hand, and a search on the other. In distinguishing the Act's sweeping recordkeeping requirement from a Fourth Amendment protected search, the Court noted the similarity with Internal Revenue Code Section 6001 which authorizes the Secretary of the Treasury to prescribe by regulation records to be kept by both businesses and individuals for tax purposes. The Court importantly also noted that (52):

"Neither the provisions of Title I nor the implementing regulations require that any information contained in the records be disclosed to the Government; both the legislative history and the regu-

lations make specific reference to the fact that access to the records is to be controlled by existing legal process."

Similarly, in rejecting Fourth Amendment challenges to the domestic and foreign reporting requirements, the Court looked at the numerous Code provisions requiring reports to the Secretary of the Treasury and third parties, such as, a report of income payments to third parties (Section 6041 (a)), a report of dividend payments (Section 6042), a broker's report of customer gains and losses (Section 6045), a bank's report of interest paid to depositors (Section 6049), etc. Based in large part on the similarity of the Act's reporting requirements with " . . . settled practices of tax collection process . . ." the Court found no Fourth Amendment search or seizure problem in connection with the Bank Secrecy Act reporting requirements.

Quite apart from reports to federal agencies required by a regulatory scheme, administrative agencies gain access to information in a regulated party's books and records in several ways. First, the agency may actually enter the regulated party's business premises and perform an on-site inspection or seizure of documents. This type of administrative inspection constitutes an "actual search" and normally requires a warrant. [See v. City of Seattle, 387 U.S. 541 (1967)] Second, the agency, by the issuance of an administrative subpoena or summons, may request the regulated party to produce specified books and records at a given time and place for review. Such a compulsory production of books or records is a "constructive search" subject to Fourth Amendment protection even though such production does not involve an actual invasion of business premises. [Oklahoma Press Pub. Co. v. Walling, 327 U.S. 186 (1946)] An actual or constructive search

may also result from a governmental request, unsupported by warrant, administrative subpoena or summons, to inspect business records at the business premises, or for the production of business books and records for review at a given time and place outside the business premises. Supreme Court and lower court decisions hold that such an oral or written request for the inspection or production of a regulated party's books and records, when made pursuant to asserted statutory authority placing the regulated party under threat of penalty for noncompliance, can constitute a governmental search subject to Fourth Amendment limitations.

An example of an actual search is found in Marshall v. Barlow's, Inc., 436 U.S. 307 (1978). There, an agent of the Secretary of Labor made an oral request unsupported by an administrative warrant to enter and inspect a business premise, including pertinent business records on the premise, to determine the regulated party's compliance with the Occupational Safety and Health Act of 1970 (OSHA). The Secretary argued that the OSHA enforcement scheme authorized and indeed required warrantless searches, and that the restrictions on search discretion contained in the Act and its regulations reasonably provided as much protection to privacy as would a warrant. The Court, however, concluded under the particular facts and statutory scheme that the requested governmental inspection constituted a search and that the search was unreasonable and thus prohibited by the Fourth Amendment.

U.S. v. Mobil Corp., 543 F. Supp. 507 (N.D. Tex, 1981), on the other hand, involved a constructive search. The issue presented was whether Section 6001 of the Code and applicable regulation (Treas. Reg. Section 31.6001-1 (e)) requiring the retention of tax records which "shall at all

times be made available for inspection" are self executing. During an audit, the IRS sent a letter to the taxpayer requesting the production of certain records relating to withholding exemptions. The documents were to be delivered to the IRS at "one or more convenient locations." The taxpayer resisted the request, claiming that an administrative summons authorized by Sections 7602-7610 of the Code was required. Under Section 7602 of the Code, the Commissioner is authorized to issue summons for the production and inspection of a taxpayer's books and records. If the taxpayer refuses to comply with the summons, the Commissioner can apply to a U.S. District Court for judicial enforcement.

The taxpayer argued that, without an administrative summons, the IRS request constituted an unreasonable search under the Fourth Amendment's limitations. The IRS declined to seek an administrative summons, taking the position that no Fourth Amendment search was involved since it allegedly had the authority under Section 6001 to inspect the designated records without a warrant or its equivalent. This was the position successfully maintained by the IRS in the case of U.S. v. Ohio Bell Telephone Company, 475 F. Supp. 697 (N.D. Ohio, 1978) which, however, did not consider the Fourth Amendment argument.

The District Court in the Mobil case rejected the IRS position, finding that the legislative history of Code Section 6001 and Sections 7602 through 7610 suggests that Congress intended to authorize inspections of documents required to be maintained by Code Section 6001 only by resort to other statutorily created procedural schemes, such as the Section 7602 summons procedures. Moreover, the District Court, relying on the Supreme Court's opinion in Marshall v. Barlow's, Inc.,

found that the IRS request for the production of tax records could be considered a search, and that a reading of Code Section 6001 so as to authorize inspection of taxpayer records without an administrative summons or its equivalent raised a serious question whether the search was reasonable under the Fourth Amendment. The District Court, quoting from the Supreme Court's opinion in the Barlow's case (436 U.S. at 320) noted that, "Delimiting the scope of a search with some care is particularly important where documents are involved."

(B) Is the governmental search reasonable?

Once it has been established that the matter at hand is a search, it must then be determined whether the search is reasonable within the meaning of the Fourth Amendment. The Supreme Court has held that a determination of the standard of reasonableness applicable to a particular class of searches requires a balancing of the nature and quality of the governmental intrusion on a person's Fourth Amendment interests against the importance of the governmental interests alleged to justify the intrusion. [O'Connor v. Ortega, 480 U.S. 709, 719 (1987); United States v. Place, 462 U.S. 696, 703 (1983); Cammaro v. Municipal Court, 387 U.S. 523, 536-537 (1967)] In a trilogy of cases beginning with Marshall v. Barlow's, Inc., including Donovan v. Dewey, and culminating in New York v. Burger, 482 U.S. 691 (1987), the Court has developed a regulatory search doctrine based on a three-part test analyzing the issue of reasonableness in connection with a warrantless administrative inspection of "pervasively regulated business." The Barlow's and Dewey cases involved business corporations. In the former, the government agent sought to examine the business premise and perti-

nent OSHA records, while in the latter case the inspection appears to have been directed at the premise only, i.e., certain stone quarries. The Burger case involved a police inspection of an individual junkyard owner's "police book"—the record of automobiles and vehicle parts in the junkyard owner's possession—followed by an inspection of the business premise. The criteria used by the Court to determine the reasonableness of a warrantless inspection conducted pursuant to an inspection statute are:

(1) There must be a "substantial" governmental interest in the subject regulated;

(2) Regulation of the subject reasonably serves the government's substantial interest and warrantless administrative inspections pursuant to the statute are necessary to further the regulatory scheme; and,

(3) The statute provides a constitutionally adequate substitute for a warrant. Namely, the statute informs the regulated party that regular inspections will be made, sets forth the scope of the inspection, notifies the party how to comply with the statute, informs the regulated party as to who is authorized to conduct the inspection, and carefully limits the discretion of the inspecting officers. [See New York v. Burger, 482 U.S. at 702-703, 708-712.]

In applying the above criteria, the Supreme Court has paid particular attention to the question whether requiring a warrant could significantly frustrate the effective enforcement of the regulatory scheme, taking into consideration the fact that an administrative warrant, subpoena or summons can be easily obtained on a showing that reasonable legislative or administrative standards for conducting an inspection are satisfied. In determining whether an administrative warrant is re-

quired, the Court has also considered whether the regulatory statute provides a mechanism for accommodating any special privacy concerns of the regulated party. In Donovan v. Dewey, relating to the Federal Mine Safety and Health Act, the Court noted that a judicial proceeding required by the Act (604-605):

“ . . . provides an adequate forum for the mineowner to show that a specific search is outside the federal regulatory authority or to seek from the district court an order accommodating any unusual privacy interests that the mineowner might have.”

However, by far the most important criterion appears to be the degree of certainty which the regulatory scheme provides as to the time, place, and scope of the inspection, thereby limiting the discretion of the inspector. For example, in Marshall v. Barlow's, Inc., where the Supreme Court concluded that a warrant was constitutionality required, the Court found that the OSHA provision authorizing administrative searches “ . . . devolves almost unbridled discretion upon executive and administrative officers, particularly those in the field, as to when to search and whom to search.” (436 U.S. at 323.) On the other hand, in Donovan v. Dewey, where the Court concluded that a program of warrantless inspections did not violate the Fourth Amendment, the Court cited the specificity of the inspection provisions of the Federal Mine Safety and Health Act and found that “ . . . the discretion of Government officials to determine what facilities to search and what violations to search for is thus directly curtailed by the regulatory scheme.” (452 U.S. at 605.)

In summary, “Where Congress has authorized inspection but made no rules governing the procedures that inspectors

must follow, the Fourth Amendment and its various restrictive rules apply.” [Colonade v. United States, 397 U.S. 72, 77 (1970)] In such cases, a warrant may be necessary to protect the regulated party from the “ . . . unbridled discretion [of] executive and Administrative officers”. [Marshall v. Barlow's, Inc., 436 U.S. at 323. See Donovan v. Dewey, 452 U.S. at 599.]

Does an IRS Request for Transfer Pricing Documents Constitute an Administrative Search?

The initial question presented under Fourth Amendment analysis of the transfer pricing penalty is whether an IRS request for a taxpayer's principal and/or background transfer pricing documents constitutes a constructive search, i.e., a compulsory production of a taxpayer's private business books or records without an actual entry or seizure or, possibly, even an actual search involving an entry and the inspection of books or records at the taxpayer's premises. Stated in other words, the issue is whether Section 6662 (e) and (h) of the Code and the applicable regulations compel a taxpayer to produce its otherwise private transfer pricing documents upon IRS request.

An examination of the statutory and regulatory provisions of the transfer pricing penalty leads to the conclusion that a persuasive argument can be made that, in operation, the penalty is intended to and does effectively compel a taxpayer to produce private business documents for government inspection; the who, how often, the when, or the where being unclear.

The transfer pricing penalty scheme is distinguishable from the Bank Secrecy Act recordkeeping and reporting regime upheld in California Bankers Ass'n. In that case, the Supreme Court stressed that IRS

access to a bank's records under the Act and its regulations

“... is to be controlled by existing legal process.” The Court considered this requirement to provide protection against an unreasonable search. A similar provision requiring the use of existing legal process, and the protection which that process provides, is missing in the transfer pricing penalty scheme. The transfer pricing penalty is not imposed for failure to file information reports with the IRS similar to those required under the Bank Secrecy Act or the Code, such as reports regarding income payments to third parties, dividend and interest payments, or reports to be filed with the tax return like those required by Section 6038A. The transfer pricing penalty is imposed for failure to produce at IRS request the transfer pricing documents which a taxpayer is now required to maintain. Those pricing documents are records which are similar to a taxpayer's private tax records required to be kept under Section 6001 of the Code and its regulations for discretionary IRS inspection on audit. The District Court in the Mobil case, in a decision which is consistent with the Supreme Court's opinion in California Bankers Ass'n, held that IRS access to Section 6001 records, even though the records are created only for government inspection, is controlled by existing legal process, namely, a summons issued pursuant to Section 7602 of the Code. This is also the legal process which is provided in Section 6038A in connection with an IRS request for access to the records required to be maintained by that section. The Section 6038A penalty is imposed for failure to maintain required records or file the required information reports; not, as in the case of the transfer pricing penalty, for failure by a taxpayer to produce its records if requested by the IRS.

A refusal by a taxpayer to produce transfer pricing documents upon IRS request does not automatically subject the taxpayer to the transfer pricing penalty. However, from a practical standpoint, a refusal to produce transfer pricing records significantly increases a taxpayer's exposure to penalty since the only issue standing in the way of the imposition of a 20% or 40% transfer pricing penalty is the question of whether there is a net Section 482 adjustment which meets the penalty threshold, i.e., the lesser of \$5 million or 10% of the taxpayer's gross receipts or \$20 million or 20% of gross receipts.

Effectively, Section 6662 (e) and (h) and the temporary regulations create two classes of taxpayers. Assuming that both taxpayers will end up with a Section 482 net adjustment in excess of the penalty threshold, the taxpayer who cooperates and produces transfer pricing documentation for IRS inspection is given the opportunity to defend against the imposition of a penalty on the basis that its transfer pricing documentation demonstrates that it used a “reasonable” transfer price. The taxpayer that does not produce transfer pricing documentation on IRS request is denied this defense against the transfer pricing penalty. Both the Congress and the IRS intend this distinction in the application of the penalty to force taxpayers to create private transfer pricing records contemporaneous with the filing of their tax return and to compel taxpayers, at the discretion of the IRS, to produce those records for IRS inspection upon its request. Thus, an IRS request for the production of principal or background transfer pricing documents may constitute a constructive search, or possibly even an actual search.

Does an IRS Request for Transfer Pricing Documents Involve an Unreasonable Search?

Accepting the proposition that the income tax, and in particular Section 482 and its regulations, are a pervasive regulation of business, the Supreme Court has established in its opinions in Marshall v. Barlow's, Inc., Donovan v. Dewey, and New York v. Burger, criteria for determining the reasonableness of a warrantless inspection conducted pursuant to a regulatory scheme. While the three Supreme Court cases cited do not involve the income tax, it appears that the criteria used in those cases may also apply in evaluating the reasonableness of an IRS request, unsupported by administrative summons, for the production of books and records which a taxpayer is required by law to maintain. See the District Court's reference to the Barlow's case in U.S. v. Mobil Corp., involving Section 6001 records.

Under the Supreme Court's three-part test there must be a "substantial" governmental interest in the subject regulated. This criterion is clearly met. It is clear that the federal government has a substantial interest in transfer pricing as a crucial aspect of collecting income tax on cross-border transactions.

Second, regulation of the subject must reasonably serve the government's substantial interest, and warrantless administrative inspections pursuant to the statute are necessary to further the regulatory scheme. The first part of the second criterion appears to be met. While arguments can be made from a policy standpoint about the wisdom and effectiveness of the transfer pricing penalty, including the authority given the IRS to request transfer pricing documents as a part of that penalty, Congress clearly has a basis for believ-

ing that the transfer pricing penalty scheme serves the government's interest in having taxpayers make a serious effort to comply with the arm's length standard for transfer pricing.

The latter part of the second criterion is debatable, however, namely that warrantless administrative inspections pursuant to the statute are necessary. Based on the legislative history of the transfer pricing penalty, it appears that Congress did not consider how the IRS request for transfer pricing documents is to be made or how the inspection is to be conducted. Moreover, based on the statutory scheme of Section 6662 (e) and (h), there does not appear to be any administrative necessity, such as a need for secrecy or surprise, for not requiring the IRS to use the existing provisions of the Code (Sections 7602-7610) to obtain an administrative summons in connection with its requests for the production of a taxpayer's transfer pricing documents.

The third criterion presents the issue whether the statute provides a constitutionally adequate substitute for a warrant or, as in the instant case, an administrative summons. The issue is whether the statutory scheme informs the taxpayer regarding the timing and regularity of inspections, sets forth the scope of the inspection, notifies the taxpayer how to comply with the statute, informs the taxpayer as to who is authorized to conduct the inspection, and carefully limits the discretion of the inspecting officer.

In applying this third criterion, the Supreme Court accepts regulations published pursuant to a statute as being part of the statutory scheme. [See California Banker's Ass'n v. Shultz, and Marshall v. Barlow's, Inc.] This is particularly true in connection with the Internal Revenue Code. Using this analysis, it can be argued that while Section 6662 (e) and (h)

and the transfer pricing penalty regulations (Section 1.6662-6T) reasonably notify a taxpayer as to the scope of the IRS inspection in connection with a request for “principal” transfer pricing documents, the statute and regulations are considerably less clear in connection with “background” documents and leave much to the examiner’s discretion. Furthermore, Section 6662 (e) and (h) and the regulations establish no criteria informing a taxpayer when and how often to expect a request for the production of documents, who in the IRS is authorized to make the request and/or conduct the inspection, how or where the inspection is to be conducted and, most important, do not effectively limit the very considerable discretion residing with the inspecting officer (e.g., the examining revenue agent) by establishing objective standards for use in conducting the inspection of a taxpayer’s private tax records.

An issue which has concerned the Supreme Court in connection with warrantless administrative inspections is the question whether the regulatory scheme provides a mechanism for accommodating any special privacy concerns of the regulated party. In *Donovan v. Dewey*, the Court noted that the Federal Mine Safety and Health Act there in issue (604-605):

“... provides an adequate forum for the mineowner to show that a specific search is outside the federal regulatory authority or to seek from the district court an order accommodating any unusual privacy interests that the mineowner might have.”

Section 6662 (e) and (h) and the transfer pricing penalty regulations do not provide a mechanism whereby a taxpayer can challenge an IRS request for transfer pricing documents or raise privacy issues without risk of incurring the penalty. At the

very least, the procedure for challenging an IRS request for documents under Section 6662 (e) and (h) is problematic.

In summary, the document production requirements of the transfer pricing penalty as they presently stand are vulnerable to the contention that they violate the Fourth Amendment’s prohibition against an unreasonable search.

Steps Which Can Be Taken to Eliminate or Reduce the Fourth Amendment Concerns

The clearest way to resolve Fourth Amendment concerns regarding the transfer pricing penalty successfully is for the IRS to issue an administrative summons in connection with a request for transfer pricing documents. Sections 7602-7610 of the Code provide the IRS with a simple administrative procedure for obtaining a summons for the production and examination of a taxpayer’s books and records. As pointed out by the Supreme Court in *Marshall v. Barlow’s, Inc.*, 436 U.S. at 320, an administrative warrant (i.e., summons) can be issued on a showing that “... reasonable legislative or administrative standards for conducting an ... inspection are satisfied with respect to a particular [establishment].” The summons procedure in Section 482 cases requires the obtaining of approvals within the IRS. [Internal Revenue Manual-Audit, Section 4022.(10)] In itself, this internal review helps to ensure an even-handed application of the authority to request a taxpayer’s transfer pricing documents. The administrative summons procedure also provides for judicial enforcement and review of a summons giving a taxpayer due process in which to raise objections against an IRS request for documents, e.g., attorney-client privilege,

attorney work product, foreign subsidiary documents which are privileged under foreign law, etc.

To the extent the IRS does not issue an administrative summons in connection with a request for transfer pricing documents it must rely on the statute and regulatory scheme as a constitutionally adequate substitute for a summons. This requires:

- A statement in the statute and/or regulation of criteria for determining when a taxpayer will be requested to produce transfer pricing documents;
- Who in the IRS is authorized to make the request and/or conduct the inspection;
- The scope of the inspection as to both principal and background documents and how the taxpayer is to comply; and,
- A procedure reasonably limiting the discretion of the examining agent in conducting the inspection.

The Supreme Court's opinions indicate that these criteria must be published and available to the regulated party, i.e., taxpayer, as a part of the regulatory scheme. [*New York v. Burger*, 482 U.S. at 711.] Internal IRS memoranda and communications, such as an IRS audit manual establishing audit criteria, are not an official part of the regulatory scheme of which the taxpayer is obliged to be aware. On the other hand, a Revenue Procedure published in the Internal Revenue Bulletin setting forth the required Fourth Amendment safeguards which the IRS is to utilize in a request for and an examination of transfer pricing documents may arguably be an official part of the published regulatory scheme and serve as " . . . a constitutionally adequate substitute for a [summons]". [*Donovan v. Dewey*, 452 U.S. at 603.] Such procedural safeguards would also help meet the criteria established in

the Commissioner's Study for a tax penalty which is fair and reasonably applied.

Conclusion

As they presently stand, the document production requirements of the transfer pricing penalty are vulnerable to Fourth Amendment objections. Ideally, the IRS would address these objections now; not later by way of possible litigation. The Fourth Amendment objections can be overcome by the issuance of an administrative summons in connection with an IRS request for transfer pricing documents. In the absence of an administrative summons, the transfer pricing penalty scheme, including the regulations and possibly a published Revenue Procedure, should include criteria which, based on Supreme Court decisions, establish Fourth Amendment safeguards for an administrative inspection of a taxpayer's records.