PPG Industries also involved the use of a low-tax jurisdiction as the location for the offshore activity in question. This fact, standing alone, was not the critical element in the court's analysis. Rather, the key factor from a pricing standpoint was the economic functions performed and risks taken in PPGI, and the evidence of prices charged by unrelated parties, which ultimately convinced the court that the pricing methodology was appropriate.[183]

[4] *Diefenthal v. United States*

The economic analysis of *PPG Industries* was, in essence, adopted in an entirely different type of situation in a 1973 decision of the Federal District Court for the Eastern District of Louisiana in 1973. In *Diefenthal v. United States,*[184] a scrap metal dealer (Scrapco) was owned by a father and two sons (each of whom owned about one third of the stock). Scrapco had a significant number of customers in Japan, and its business required loading scrap on ocean carriers and shipping the scrap to Japan. In order to minimize the transportation costs, Scrapco entered so-called voyage charters that would fix the cost of the trip, regardless of the occurrence of unforeseen delays or problems. One of the sons (Stanley) believed that Scrapco could make a significantly greater return if it were to enter time charter contracts, which would involve a fixed rate per time period for the trip. If the trip occurred without unforeseen delay and difficulty, such an arrangement would result in significantly lower costs, but Scrapco would incur the risk of any such delays and difficulties. At the time, Stanley's father was in control of Scrapco, and he adamantly believed that Scrapco's business was scrap metal and that it should not engage in the unknown dangers of the ocean shipping business.

Thereafter, Stanley formed his own company (Fukaya, which initially was a domestic corporation but eventually was replaced by a Panamanian corporation) to conduct such an ocean shipping business. Fukaya functioned as an agent for Scrapco and arranged time charter contracts for the shipment of scrap metal to Japan. Scrapco would enter voyage charters with Fukaya, which would in turn enter time charters with ship owners. Fukaya assumed the speculative risk relating to the unforeseen delays and difficulties of the voyage, which the court viewed to "add substance to the transactions."[185] While some shipowners required guarantees from Scrapco of Fukaya's performance, the court found that Fukaya was, in effect, adequately capitalized so that the accommodation guarantee did not alter the substance of the transactions.[186] During the year in question (1966), there were seven voyages. Fukaya made a profit on six voyages but had significant losses on one voyage and a potential loss on an earlier voyage.

---

[183] See ¶ 3.02[1].

[184] Diefenthal v. United States, 367 F. Supp. 506 (ED La. 1973).

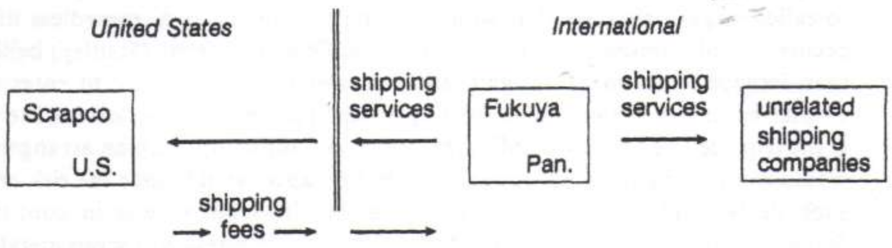
[185] Diefenthal v. United States, 367 F. Supp. 506, 510 (ED La. 1973).

[186] Diefenthal v. United States, 367 F. Supp. 506, 510 (ED La. 1973).

In establishing the charter prices between Scrapco and Fukaya, Stanley (the owner of all Fukaya stock and one third of the Scrapco stock) would call a broker and ask for charter rates of a ship of sufficient size to undertake the voyage, and the agent would provide quotes, which would vary depending upon the position of the respective ships (distance from the port of loading, New Orleans). Stanley accepted the best price on behalf of Fukaya. Stanley also made inquiries of brokers to determine the prevailing market rates for voyage charters for similar trips and vessels. Stanley would then arrange a voyage charter between Fukaya and Scrapco, which would be set "slightly below market, in order to be sure that Scrapco, and all of its owners, were being treated fairly, and also to compensate Scrapco for [Stanley's] time and the time of other Scrapco employees who did work on the charters."[187]

The pattern of the case is illustrated in Figure 2.3.

FIGURE 2.3



Upon examination, the Service challenged the arrangement and sought to allocate a significant part of the chartering income to Scrapco under Section 482. The court held that the allocation was inappropriate. It found that Section 482 was applicable because common "control" was present,[188] but it found that the taxpayer had demonstrated that the voyage charters had been established in a manner that would, in effect, satisfy the comparable uncontrolled price method (the issues were actually service charges).[189]

Scrapco introduced the testimony of a partner in a ship brokerage house (who had done no work for Scrapco or Fukaya) as an expert witness with respect to the market for voyage charters. This expert testified based on his knowledge of actual comparable contracts from his firm, as well as on a statistical compilation (Maritime Research, Inc.'s Chartering Annual 1966), and stated that "the market was higher than the price Fukaya charged Scrapco."[190] A second expert

---

[187] Diefenthal v. United States, 367 F. Supp. 506, 512 (ED La. 1973).

[188] See ¶ 3.05.

[189] See ¶¶ 4.05, 6.02[4][a].

[190] Diefenthal v. United States, 367 F. Supp. 506, 512 (ED La. 1973). The use of experts in this type of situation is discussed at ¶ 10.03[5][a].

witness was a member of the brokerage firm used by Fukaya, and he also testified based on actual comparable contracts, the statistical compilation, and his own notebook concerning contracts that he heard from other agents.

The second expert indicated a market rate slightly lower than the first expert, which rate equalled about $2,009 higher than the average price based on over $1 million of contracts. In this connection, the second expert prepared a table showing the results of the various third parties included in his testimony.[191]

The court found that this expert testimony adequately demonstrated that the Fukaya-Scrapco pricing was arm's length in nature (as supported by uncontrolled transactions).

The expert testimony in *Diefenthal* was given credence for comparability purposes because the experts were able to testify from personal knowledge concerning transactions involving uncontrolled parties, which information was, in effect, used to compile a guide to market rates for voyage charters at the time in question. They were also able to demonstrate that the nature of the service (not goods) was similar to the matter in question. Finally, the experts were able to confirm their personal analyses with published statistical information on such rates, which data could, again, be demonstrated to involve similar matters to the pricing subject at hand.

(A) Vessel	*(B)* Lump-Sum Price	*(C)* Tons	*(D)* Charge/Ton	*(E)* Market Charge/Ton	*(F)* Difference (E - D)	*(G)* Discrepan (C × F
Hereford Beacon	$ 155,000	12,500	12.40	13.50	1.10	13,750
Atlantic Sunrise	153,000	13,150	11.56	12.88	1.32	17,358
Atlantic Sun	143,000	13,150	10.87	10.54	(0.33)	(4,339)
Etnepjell	175,000	15,100	11.59	11.15	(0.44)	(6,644)
Thorsodd	190,000	17,000	11.18	10.51	(0.67)	(11,390)
Irish Rowan	157,500	14,000	11.25	11.11	(0.14)	(1,960)
Hadjitsakos	165,000	14,400	11.46	10.85	(0.61)	(8,784)
	$1,138,000					(2,009)

Diefenthal is a fascinating case. The economic logic of the taxpayer's experts and method of analysis of the court have ultimately been reflected in the regulations and methodology of the courts.[192] Interestingly, *Diefenthal* has rarely been cited by either courts or commentators.[193]

[191] Diefenthal v. United States, 367 F. Supp. 506, 514 (ED La. 1973).

[192] See ¶¶ 4.04[5][d], 6.05[3][f]. *Diefenthal* reflects a rather straightforward application of the pricing principles noted supra ¶ 2.03[1].

[193] The significance of the case was plainly recognized in Fuller, "Section 482 Revisited," 31 Tax L. Rev. 475, 498–499 (1976).