> disagrees with this or that detail in the calculation. [DuPont] never made that effort, and it would have been undiluted luck—which under the regulation it probably could enjoy—if it had managed to discover comparable resales falling within the resale price method.[206]

The court then evaluated the testimony of the expert witnesses of the government, which evaluation was significant in its own right. The court in this case produced one of the most famous margin analyses in pricing law, still in active use: the "Berry Ratio." The Berry Ratio obtained its name from Professor Charles Berry, one of the government's witnesses.[207]

The *DuPont* case is plainly one of the most significant pricing cases for a variety of reasons, not the least of which is that it is one of the few unconditional victories for the government in major pricing cases. In addition, the methods of analysis used by the government's experts and by the court were subsequently adopted in the temporary regulations released in 1993.[208]

As in *PPG Industries* and *Diefenthal*, the foreign-based company in *DuPont* was located in a tax-efficient jurisdiction. But unlike the factual situation in *PPG Industries* and *Diefenthal*, the court in *DuPont* found that the functions performed and economic risk taken in DISA could not be justified by any comparable unrelated transactions or by other credible economic evidence.

[6] *United States Steel Corporation v. Commissioner*

The pattern of *PPG Industries* and *DuPont* involved the formation of foreign sales corporations to conduct certain activities in an offshore location and in tax advantageous jurisdictions. In both cases, the pricing issue involved the extent to which the activities of the offshore sales company justified the return that it reported.[209]

Similar issues in a services context (as in *Diefenthal*) were involved in *United States Steel Corporation v. Commissioner*,[210] in which the taxpayer was a major U.S.-based, vertically integrated producer of steel products (USS). It owned iron ore mines in the United States and abroad. In 1949, USS formed Orinoco Mining Company (Orinoco), a wholly owned Delaware subsidiary, to own and exploit new Venezuelan mines.

Orinoco began selling ore from its mines in 1953. Initially, the ore was transported to the United States in chartered vessels owned by independent companies, but in 1953 USS incorporated another wholly owned subsidiary,

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[206] EI DuPont de Nemours & Co. v. United States, 608 F2d 445, 454 (Ct. Cl. 1979).

[207] See ¶¶ 4.08[2][d], 4.10, 10.03[5][b].

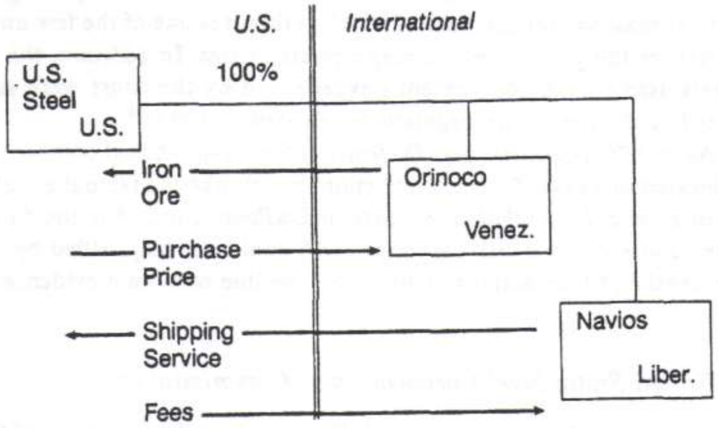
[208] See ¶ 4.10.

[209] Distribution operations are discussed at ¶ 6.05[3][e].

[210] United States Steel Corp. v. Comm'r, 617 F2d 942 (2d Cir. 1980), rev'g 36 TCM 586 (1977). Important aspects of the case are discussed at ¶¶ 3.02[1] (role of purpose), 4.05 (the comparable uncontrolled price method), and 6.02[3][d] (services).

Navios, Inc. (Navios), in Liberia, with its principal place of business in Nassau, Bahamas. Initially, Navios was organized for the purpose of chartering ore carriers for transporting iron ore mined by Orinoco. Accordingly, Navios entered shipping agreements with third parties, which, in effect, assumed preexisting obligations of USS, and which USS guaranteed.[211] The pattern of the case is illustrated in Figure 2.5.

FIGURE 2.5



USS and Navios had extensive discussions over time concerning the charges for the ocean transportation. Initially, the charges were structured on a cost plus 10 percent basis to Navios and were thereafter increased to a 20 percent mark up.[212] It had been contemplated that large, deep draft carriers could be used to transport ore from the mines of Orinoco, but the channel of the river was not sufficiently deep. This difficulty increased the originally contemplated transportation costs by requiring Navios to charter more ships that were smaller and could navigate the channels. By 1959, the river had been dredged to permit deeper drafts, and more modern ore carriers were used, reducing Navios's costs and, in turn, the rates charged to USS. As such costs were reduced, the savings were passed on to USS and other customers.[213] In setting its rates, Navios did not take into account whether unrelated ship owners or operators "would be willing

[211] The consequences of guarantees under Section 482 concepts are discussed at ¶ 6.03[5].

[212] United States Steel Corp. v. Comm'r, 36 TCM 586, 593 (1977).

[213] The Tax Court noted that

> [i]n establishing the transportation rates to be charged by Navios . . . , the parties were cognizant of the fact that there would be a substantial savings in the cost of transportation as a result of deepening the channel from [the mine] to open water and the utilization of the larger and more specialized ore carriers.

United States Steel Corp. v. Comm'r, 36 TCM 586, 593 (1977).

to undertake the transportation of such ore and the rates that those unrelated operators would charge on a long term basis."[214]

During the years in question, Navios had personnel located in the Bahamas, Uruguay, and Venezuela who conducted its operations. The court appeared to indicate that these people had the necessary expertise for these purposes.[215] In 1959, it was decided that the Venezuelan and non-Venezuelan activities of Navios should be separated, so USS formed a new company that assumed the non-Venezuelan activities from Navios.[216]

Although USS was by far the largest customer of Navios, Navios sold its transport services to other domestic steel producers and to foreign steel companies. The prices charged by Navios to other domestic steel companies during the relevant period were the same as those charged to USS, though the rates charged to companies importing ore to countries other than the United States were different. The prices were structured in a manner so that the delivered cost of iron ore would not be below the price charged by USS for ore from its U.S. mines.[217]

In the tax years 1957 through 1960 (essentially the same periods as *PPG Industries* and *DuPont*), Navios earned approximately $391 million in gross revenues, all from the transport of iron ore from Venezuela to various points in the eastern continental United States and in Europe. Of this total, revenues from USS amounted to $286 million, or 73 percent of the total; from independent domestic steel purchasers $21 million, or 5 percent of the total, and the remaining 22 percent from foreign steel companies. From 1957 through 1960, there was no information publicly available from which a market price for the transport of iron ore by sea could be determined.[218] Unlike the practice in the oil tanker industry, for example, ship charter contract prices for ore carriage were not published.

In terms of the overall arrangement, the Tax Court made the following comment:

> One of the primary considerations, if not the controlling consideration, for thus separating the mining function from the transportation function was to enable [USS] to minimize the taxes due to Venezuela by limiting its reach to the income attrib-

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[214] United States Steel Corp. v. Comm'r, 36 TCM 586, 594 (1977).

[215] United States Steel Corp. v. Comm'r, 36 TCM 586, 594-595 (1977).

[216] United States Steel Corp. v. Comm'r, 36 TCM 586, 597-598 (1977). The Service apparently did not raise any issue concerning this restructuring.

[217] The Tax Court had noted that

> [USS] was not willing to provide access to the Venezuelan ore on a delivered basis which would be below the delivered price of Mesabi ore. Accordingly, the transportation charges for delivery of the ore to United States ports were established as of April 1 of each year at a price per ton to U.S. ports which, when coupled with the F.O.B. price of the ore at Puerto Ordaz and port charges, would be compatible with the lower Lake Erie price for the Mesabi ore.

United States Steel Corp. v. Comm'r, 36 TCM 586, 588 (1977).

[218] The court did not note the methodology presented to the court in *Diefenthal*. See supra notes 184-193.

utable to the mining of the ore. Consistent therewith [USS] established a price for the ore F.O.B. Puerto Ordaz, Venezuela, at which price such ore would be sold to any and all producers of steel either in the United States or in other countries.

With respect to the transportation charges, Navios enabled [USS] to provide for the transportation of the ore from Venezuela to United States ports, as well as to foreign buyers, without subjecting the income realized therefrom to tax either in Venezuela or in the United States. In addition, Navios could obtain the savings attributable to "foreign flag" operations to the extent that Navios might ultimately decide to own or to operate the ships itself. The decision thus to divorce the shipping operations from the mining operations was a sound business decision not subject to question because the avoidance of United States income taxes was also a consideration.[219]

The Service determined that Navios had overcharged USS by 25 percent (plus a port differential) and allocated income from Navios to USS as follows:

Taxable Year	*Amount Allocated*
1957	$11,072,585
1958	13,042,107
1959	13,624,330
1960	14,402,384
	$52,141,406

The Tax Court reviewed the history of USS's relations with its subsidiaries Navios and Orinoco and concluded that a Section 482 reallocation was justified because USS had caused Navios to charge rates such that at all times the delivered price of Orinoco origin ore in the United States was equivalent to the prevailing U.S. market price. In the Tax Court's view, this equivalence served several purposes. First, it protected USS's interest in the revenues of its U.S. mining subsidiary; second, because USS could be sure of selling its Orinoco production as long as the delivered U.S. price did not exceed the U.S. market price of iron ore, it enabled USS to earn extra profits; and third, such extra profits were not subject to Venezuelan tax and were sheltered from U.S. tax.

The Tax Court used two alternative means of arriving at what Navios's revenues would have been had it charged a market price for its services. First, it extrapolated hypothetical rates for 1957 through 1960 from what certain independent shippers had charged in their 1954 contracts with USS, adding adjustments to account for increased cost, risk, and profit.[220] As a check on the accuracy of this historical approach and to determine the amount of allocation, the court also constructed hypothetical rates based on estimates of what Navios's costs had been in the taxable years in question, adjusting these estimates to allow for risk and profit, and then chose the method that, for each taxable year, would result in the lowest reallocation in favor of the Service.

[219] United States Steel Corp. v. Comm'r, 36 TCM 586, 601 (1977).

[220] United States Steel Corp. v. Comm'r, 36 TCM 586, 604 (1977).

The figures arrived at by the Tax Court provided for reallocation of income as follows from Navios to USS:

Taxable Year	*Amount Allocated*
1957	$ 2,300,000
1958	4,500,000
1959	12,200,000
1960	8,000,000
	$27,000,000

The decision of the Tax Court was reversed on appeal.[221] The court noted that the prices charged to USS were the same as those charged to third parties. It also noted that Navios was a highly successful venture that had become, in effect, an offshore tax shelter.[222] But this was not, standing alone, a justification for a reallocation of income under Section 482, since Navios also "served a major business purpose unrelated to tax-shifting: allowing Steel to reap cost savings of using a non-United States-flag fleet."[223]

After reviewing the logic of the Tax Court's analysis, the Second Circuit concluded that no adjustment was appropriate. It found that USS had amply met the standards of the Section 482 regulations:

> We think it is clear that if a taxpayer can show that the price he paid or was charged for a service is "the amount which was or would have been charged for the same or similar services in independent transactions with or between unrelated parties," it has earned the right ... to be free from a § 482 reallocation despite other evidence tending to show that its activities have resulted in a shifting of tax liability among controlled corporations. Where, as in this case, the taxpayer offers evidence that the same amount was actually charged for the same service in transactions with independent buyers, the question resolves itself into an evaluation of whether or not the circumstances of the sales to independent buyers are "similar" enough to sales to the controlling corporation under the circumstances, "considering all relevant facts." In our view, "considering all the relevant facts," the evidence was sufficient to show similar enough transactions with independent buyers to establish that the price [USS] paid Navios was an arm's length price.[224]

The analysis and the result in *U.S. Steel* is quite similar to that of the Tax Court in *PPG Industries* and *Diefenthal*, in the sense that the court recognized that significant tax savings were inherent in the offshore structure adopted but that it found that this was not sufficient, standing alone, to support an allocation under Section 482. Rather, the presence of pricing for the shipping services

[221] United States Steel Corp. v. Comm'r, 617 F2d 942 (2d Cir. 1980).

[222] United States Steel Corp. v. Comm'r, 617 F2d 942, 945 (2d Cir. 1980).

[223] United States Steel Corp. v. Comm'r, 617 F2d 942, 945 (2d Cir. 1980). The role of purpose is reviewed at ¶ 3.02[1].

[224] United States Steel Corp. v. Comm'r, 617 F2d 942, 947 (2d Cir. 1980). The pertinent provisions of the service charge regulations are reviewed at ¶ 6.02[3][d][i].

rendered at the same rates charged to third parties was sufficient to establish an arm's length relationship under the pertinent provisions of the regulations,[225] as in *PPG Industries* and *Diefenthal*, but this presence was not shown in *DuPont*.

[7] *Hospital Corporation of America v. Commissioner*

The pattern of *PPG Industries*, *DuPont*, and *U.S. Steel* involved the formation of offshore companies by a U.S. parent to conduct sales or service operations. In each case, the courts found that the offshore subsidiary had the capacity to conduct its business operations, though in *DuPont* it was found that an allocation from the offshore company was appropriate.

A significantly different situation was present in *Hospital Corporation of America v. Commissioner*,[226] in which a U.S. parent company (HCA) was formed in 1960 and became a major owner and manager of hospitals. It developed significant expertise in the management of hospitals, as well as a series of copyrighted manuals that compiled some of its expertise.

In 1972, HCA received an inquiry whether it would be interested in managing a new hospital being built in Riyadh, Saudi Arabia, the King Faisal Specialist Hospital (KFSH). HCA indicated that it would be interested in pursuing the project and arranged an initial visit to Saudi Arabia. The executive who made the visit returned enthusiastic about pursuing the discussions, though it was anticipated that "the project would be difficult, unique, and prestigious."[227] HCA then arranged for a team to engage in more detailed discussions in Saudi Arabia, which discussions occurred in May 1973.

HCA decided that it would not become directly involved in international operations, and accordingly, formed two Cayman Islands corporations on May 28 and 29, 1973: a parent (Hospital Corp. International, Ltd. (HCI One)) and a subsidiary (Middle East, Ltd. (LTD)). There were several reasons for incorporation in the Cayman Islands:

> The islands were an English-speaking jurisdiction with familiar corporate codes; they had a stable government; they were readily accessible to the United States; and they imposed no corporate income taxes, if certain conditions were met.[228]

HCA had similarly formed separate corporations to own each of its hospitals and used a separate subsidiary to carry out its management contracts. The two corporations were formed under a provision of the Cayman Islands law that exempted them from tax, provided that their activities were carried out mainly outside the Cayman Islands.

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[225] See ¶ 6.02[3]. Interestingly, the Second Circuit in *U.S. Steel* did not discuss or refer to *PPG Industries*, *Diefenthal*, or *DuPont*.

[226] Hospital Corp. of Am. v. Comm'r, 81 TC 520 (1980). The case is discussed at ¶¶ 5.04[1] and 6.03[3][d][iii].

[227] Hospital Corp. of Am. v. Comm'r, 81 TC 520, 530 (1980).

[228] Hospital Corp. of Am. v. Comm'r, 81 TC 520, 532 (1980).