Edited: 2/23/04

=H1 Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today@

=N1 Michael C. Durst*

Robert E. Culbertson**

---

* Partner, King & Spalding LLP, Washington, D.C.

** Partner, King & Spalding LLP, Washington, D.C. The authors are grateful for the many helpful suggestions that commentators offered on a prior draft of this Article in connection with a seminar conducted by the American Tax Policy Institute on July 11, 2002. The authors also gratefully acknowledge the invaluable assistance of our colleague David Bailey, who managed to correct most of our errors and fill most of the gaps we left gaping—any that remain are naturally our responsibility. We also wish to thank Kimberly Byrd for her valuable help in handling administrative aspects of this project, and the King & Spalding Library for its resourcefulness in locating sometimes unusual materials. The support of the American Tax Policy Institute is greatly appreciated.

=C1 I. Introduction. 000
=C1 II. Historical Background: Transfer Pricing Through the U.S. Tax Reform Act of 1986. 000
=C2 A. Developments Before 1962: An Academic Pursuit. . 000
=C2 B. The Revenue Act of 1962: Flirting With Formulas 000
=C2 C. The 1968 Regulations: Comparables Enshrined. . . .000
=C2 D. The Post-1968 Case Law: Ascendancy of Economic Experts. 000
=C2 E. Congressional Action in the 1980's : The "Commensurate With Income" Rule.. 000
=C1 III. Recent History: How the Camel Acquired Its Current Form. 000
=C2 A. The White Paper: Treasury Builds a BALRM, But Nobody Wants to Dance. 000
=C3 1. Central Economic Argument: Economies of Integration and the Likely Paucity of Comparables. 000
=C3 2. The White Paper's Transfer Pricing Methods. 000
=C3 3. An Ex Post Critique of an Ex Post Approach: The White Paper, Profit-Split Methods, and Cost Sharing . . .000
=C3 4. Procedural Concerns of the White Paper: Toward a Fundamental Change in the Landscape 000
=C2 B. The Debate Over Net Income Benchmarking. 000

=C3 1. The 1992 Election and the Arm’s Length Standard. . 000

=C3 2. Criticism of Net Income Benchmarking. 000

=C4 a. General Criticism of Reduced Reliance on Comparables 000

=C4 b. Criticism of Claims Regarding Net Profit Analysis. 000

=C4 c. Criticism of Underlying Economic Theory 000

=C4 d. Practical Problems in Applying the BALRM Approach .000

=C3 3. Sewing the Camel Together: The Regulatory Process and the OECD. .000

=C2 C. Major Features of the Regulations and Guidelines. .000

=C3 1. Traditional Measures to Be Used When Feasible. . . 000

=C3 2. “Profit Based” Methods to Be Used When Transactional Methods Unavailable. 000

=C4 a. CPM/TNMM. 000

=C4 b. Profit Split Methods under the Regulations and Guidelines. .000

=C3 3. Cost Sharing Under the Final Regulations and Guidelines. 000

=C3 4. Permissibility of “Other” Methods. 000

=C3 5. “Documentation” Under the Regulations and Guidelines. 000

=C1 IV. Current Practice: Evaluating the Regulations and Guidelines Based on Practical Experience. 000

=C2 A. An Incomplete Paradigm Shift. 000

=C3 1. Root of the Dilemma: Conflict Between Ex Ante Procedural Rules and Ex Post Substantive Rules. . 000

=C3 2. The "Joint Venture" Component of the Arm's Length Standard. 000

=C2 B. Particular Areas of Difficulty With the New Rules 000

=C3 1. Different Pathways Into the Same Wilderness: The Evaluation of Comparables Under the Guidelines and Regulations. 000

=C4 a. The Guidelines: Factual Inquiry Is Essential, but No Amount Could Possibly Be Adequate. 000

=C4 b. The U.S. Regulations, Computerized Databases, and the Interquartile Range: Trying With Statistics. . . .000

=C3 2. Ex Ante Contracts Under the Regulations and Guidelines. .000

=C4 a. Ex Ante Agreements in General. 000

=C3 3. A Particular Kind of Ex Ante Agreement: APAs . . .000

=C2 C. Absence of Safe Harbors. 000

=C1 V. Proposals for Improvement. 000

=C2 A. Half a Loaf vs. Pie in the Sky: The Joys of Incremental Improvement. 000

=C2 B. Specific Proposals. 000

=C3 1. Encourage the Use of Ex Ante Contracts. 000

=C3 2. Clarify the Limits of Statistical Methods. 000

=C3 3. Provide Limited Safe Harbors for Use With Income-Based Methods. 000
=C3 4. Begin Consideration of Safe Harbor Lives for Expenditures Intended to Generate Intangibles . . .000
=C1 VI. A Mildly Hopeful Conclusion. 000

The Walrus and the Carpenter
Were walking close at hand;
They wept like anything to see
Such quantities of sand:
'If this were only cleared away,'
They said, 'it would be grand!'

'If seven maids with seven mops
Swept it for half a year,
Do you suppose,' the Walrus said,
'That they could get it clear?'
'I doubt it,' said the Carpenter,
And shed a bitter tear.[1]

[1] Lewis Carroll, Through the Looking-Glass and What Alice Found There, in The Annotated Alice 184 (Martin Gardner ed., W.W. Norton 2000) (1872).

=S1 I. Introduction@

This Article evaluates the current generation of transfer pricing rules based on several years of practical experience with their implementation, and offers suggestions to enhance their effectiveness. Based on an analysis of the historical, economic, and legal aspects of the current system, we conclude that transfer pricing compliance is in a state of significant instability, an instability that will require important changes to the system in the coming years. While we believe that the necessary changes can be accomplished incrementally within the boundaries of the "arm's length" paradigm, the changes needed are significant, and current systemic difficulties indicate that they should be effected promptly.

While much of the Article focuses on the current rules and suggestions for their revision, there is also a strong historical element to our analysis. This reflects our belief that an understanding of the shortcomings of current approaches, and especially of the degrees to which different components of the current system realistically might be subject to change, requires an understanding of how the rules acquired their current form.

A relatively recent chapter in the history of the current rules, the policy debate that produced the current U.S.

regulations[2] and the current OECD Guidelines[3] had a particularly unfortunate characteristic: Arguments both for and against the U.S. initiatives that triggered the debate tended to be cast in the form of largely symbolic, and essentially peripheral, disagreements over terminology, such as whether particular proposals conformed excessively to "unitary" or "formulary" models as opposed to the "arm's length standard," and whether particular measures were "transactional" as opposed to "profit-based." The symbolic tenor of the debate deflected attention from the underlying conceptual issues, as well as from even the most basic questions of practical implementation.

The highly theoretical tone of the policy debate, and its inattention to questions of practical implementation, resulted in an international consensus that uneasily maintains the core of the traditional approach to transfer pricing, in that enforcement remains based primarily on retrospective reference to uncontrolled comparables, while at the same time making a nearly unacknowledged yet fundamental procedural change to the system, by shifting transfer pricing enforcement to a self-

---

[2] Reg. § 1.482.

[3] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995, as supplemented through 1999) (hereinafter "OECD Guidelines").

assessment mode. The new procedural requirements, possibly to the surprise of some of the participants in the recent debates, have transformed transfer pricing compliance into a large-volume exercise, to which virtually all multinational companies today must devote substantial resources. The underlying substantive rules that emerged from the recent debates, however, were designed for use under an entirely different enforcement paradigm, based largely on the concept of relatively small-scale enforcement activities, conducted retrospectively by government specialists, and focused on a limited group of taxpayers.

As a result, transfer pricing compliance and enforcement have been left in a state of significant instability today, an instability that will require important changes to the system in the coming years. The defects in current practices are readily apparent to participants in the transfer pricing process, who often approach the subject with a level of skepticism and irony (often expressed in private exchanges among practitioners, and occasionally in print[4]) that in the long term cannot be conducive to a sustainable system. Substantial time has passed since the debates of the late 1980's and early 1990's, and a reevaluation based on practical experience to date thus seems timely and desirable.

---

[4] See note 272 and accompanying text.

The detailed analysis below sets forth our view that there are serious defects in the current transfer pricing system. We do not suggest, however, any sweeping changes, such as the adoption of a formulary system to replace the current approach. While the pros and cons of such a radical change have been the subject of much dispute,[5] rather than adding to that debate, we have opted for what we believe to be the more practical path of advocating incremental changes that can be implemented in the real world in the immediate future. Moreover, the discussion

---

[5] For some examples, see Eric J. Coffill & Prentiss Willson Jr., Federal Formulary Apportionment as an Alternative to Arm's Length Pricing: From the Frying Pan to the Fire?, 59 Tax Notes 1103 (May 24, 1993); Charles E. McLure Jr., U.S. Federal Use of Formula Apportionment to Tax Income From Intangibles, 14 Tax Notes Int'l 859 (Mar. 10, 1997); Benjamin F. Miller, None Are So Blind As Those Who Will Not See, 66 Tax Notes 1023 (Feb. 13, 1995); Joann M. Weiner, Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level (OTA Paper 83, 1999), available at http://www.ustreas.gov/ota/ota83.pdf; William J. Wilkins & Kenneth W. Gideon, Memorandum to Congress: You Wouldn't Like Worldwide Formula Apportionment, 65 Tax Notes 1259 (Dec. 5, 1994).

retains the availability of all aspects of the current system, such as reliance on comparable uncontrolled transactions, for those taxpayers that find them to be desirable and wish to use them. The political resolution of the mid-1990's suggests strongly that limiting such access would be inappropriate.

Instead, this Article suggests several means by which companies that wish to reduce compliance costs and achieve a higher degree of certainty under the current system might obtain greater ability to do so, while otherwise leaving the current structure largely intact. These suggestions are based in part on the hope that, during the time that has elapsed since the mid-1990's, the tenor of debate has sufficiently cooled, and shortcomings of some elements of the current system have manifested themselves sufficiently clearly, to permit incremental reforms without seriously upsetting the political balance that resulted in the OECD Guidelines and the current regulations.[6] In large measure, we base our suggestions on a

---

[6] In the relatively short time during which this Article was initially drafted, discussed in draft form in a seminar setting, and prepared for publication, it appears that political alignments have shifted in a way that may increase the likelihood of changes to transfer pricing rules that are more fundamental than those suggested in this Article. See notes

concept that has been present in transfer pricing rules and practice virtually from their inception but which, for many reasons, policymakers rarely have articulated: namely, that ex ante agreements among entities to conduct business under commercially reasonable terms may conform as fully to the arm's length model as does ex post verification of pricing based on the analysis of comparables.

Our suggestions are as follows:

1. Both taxpayers and tax authorities should place greater reliance on the potential for taxpayers to reduce controversy and compliance costs through greater use of explicit ex ante agreements among related entities. This should be feasible without changes to current rules, although some modifications of existing rules could facilitate such reliance.

2. Treasury should modify the regulations to clarify the appropriate use of statistical methods, and their limitations.

314-316 **[x]** and accompanying text. Even if that is the case, however (and political predictions, it must be remembered, are hazardous), we hope that the analysis provided in this Article will assist in the design of whatever fundamental reforms are considered desirable.

3. Tax authorities should provide safe harbor arm's length ranges for application in certain specifically defined and recurring situations.

4. Tax authorities should give consideration to the adoption in the longer term of more ambitious safe harbors based on a joint venture profit split method, by beginning to study the possibility of prescribing safe harbor lives for expenditures intended to generate intangible assets.

Sections II and III review in some detail the early history of transfer pricing enforcement and the more recent controversies that have brought us to the current state, highlighting the somewhat unstable compromises embodied in the current rules. Our critique of those aspects of the current system that are proving troublesome in practice is set forth in Section IV. Section V describes the additional changes that we believe to be necessary based on the difficulties of current practice, offering suggestions for improvement that we believe to be incremental and practicable yet significant. Section VI is a brief conclusion.

=S1 II. Historical Background: Transfer Pricing Through the U.S. Tax Reform Act of 1986@

Virtually all countries impose some kind of tax on the incomes of corporate businesses, and those countries generally

agree that the income of a business that operates in more than one country should be taxed only once, with each country generally having the right to tax income that is attributable to business conducted within its boundaries.[7] Rules for dividing the income of multinational businesses among the jurisdictions in which they conduct business therefore play a central role in the corporate tax rules around the world. Because these rules historically have been articulated as rules governing the prices

---

[7] Some countries operate under an exemption system, under which only income earned within the country's boundaries generally is subject to taxation; other countries, including the United States, operate under a worldwide system of taxation, under which entities resident in the home country theoretically are taxed on all their income earned globally. See Ernest R. Larkins, Double Tax Relief for Foreign Income: A Comparative Study of Advanced Economies, 21 Va. Tax Rev. 233, 235 (2001). Those countries that tax on a worldwide basis, however, allow their resident taxpayers credits against taxes paid to other countries on income earned abroad. Id. Moreover, countries taxing on a worldwide basis will assert tax jurisdiction over the income earned within their borders by foreign taxpayers. Thus, rules for dividing income among jurisdictions are required under both exemption-based and worldwide systems.

used in transactions conducted among commonly controlled companies, the rules typically are described as transfer pricing rules.

=S2 A. Developments Before 1962: An Academic Pursuit@[8]

Prior to World War I, problems of apportionment seem to have attracted official attention only within federal systems of a single country or closely allied groups of countries with particular political affinities.[9] As a result, traditional conceptions of the arm's length standard became established in

---

[8] Reuven S. Avi-Yonah, The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation, 15 Va. Tax Rev. 89 (1995) [hereinafter Rise and Fall], and Stanley I. Langbein, The Unitary Method and the Myth of Arm's Length, 30 Tax Notes 625 (Feb. 17, 1986), provide excellent historical surveys. As indicated in the notes below, the historical discussion in this Article has benefited greatly from their discussions.

[9] See Langbein, note 8, at 629-30 (indicating that "[p]rior to World War I, the problem of 'double taxation' of income apparently rarely occurred," and citing various formulary systems in effect within Switzerland and the Austro-Hungarian and German Empires).

the vocabulary of international taxation before they had been widely tested in practice.

The increase in tax rates brought about by the war, however, raised the potential practical consequences of double taxation and elicited increased attention to the problem both in the United States and abroad.

In the United States, Congress first addressed the question in connection with what the legislative history described as the practice of using foreign subsidiaries to "milk" the income of U.S. parent companies.[10] Thus, in 1921, Congress enacted legislation permitting the government to require consolidated accounting of groups of related corporations "for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or business."[11] In 1928, Congress reformulated

---

[10] Avi-Yonah, note 8, at 95, quoting H.R. Rep. No. 67-350, at 14 (1921) ("Subsidiary corporations, particularly foreign subsidiaries, are sometimes employed to "milk" the parent corporation, or otherwise improperly manipulate the financial accounts of the parent company.").

[11] Revenue Act of 1921, Pub. L. No. 67-98, ch. 136, § 240(d), 42 Stat. 227, 260.

the 1921 enactment into language that, with remarkably little modification, remains in effect today in § 482.[12]

Internationally, the League of Nations began an extended discussion of the general problem of double taxation in the early 1920's.[13] As a part of this process, in late 1929 or early 1930, Thomas S. Adams of Yale University procured a grant from

---

[12] The 1928 legislation provided:

=xt

> In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such trades or businesses.

=ft

Revenue Act of 1928, Pub. L. No. 70-562, ch. 852, § 45, 45 Stat. 791, 806. Avi-Yonah, note 8, at 96 n.24, enumerates the changes that have been made to this language since 1928: "Among the few changes, 'Organizations' was added to 'trades or businesses,' 'credits or allowances' were added to 'gross income or deductions,' and 'the Secretary or his delegate may' was substituted for 'the Commissioner is authorized to.' "

[13] Langbein, note 8, at 630.

the Rockefeller Foundation to fund a League of Nations study of income apportionment.[14] The League of Nations delegated much of the analytical work to Mitchell B. Carroll, a lawyer who had been Adams' assistant,[15] and the resulting League of Nations report of 1934 articulated what soon came to be regarded as the international consensus on the topic.[16]

---

[14] Id. at 631.

[15] Id.

[16] The League of Nations published the study in four volumes: 1 Taxation of Foreign and National Enterprises (France, Germany, Spain, the United Kingdom, and the United States of America), League of Nations Doc. C.73.M.38.1932.II.A. (1932); 2 Taxation of Foreign and National Enterprises (Austria, Belgium, Czechoslovakia, Free City of Danzig, Greece, Hungary, Italy, Latvia, Luxemburg, Netherlands, Roumania and Switzerland), League of Nations Doc. C.425.M.217.1933.II.A. (1933); 3 Taxation of Foreign and National Enterprises (British India, Canada, Japan, Mexico, Netherlands East Indies, Union of South Africa, States of Massachusetts, New York, and Wisconsin), League of Nations Doc. C.425(a).M.217(a).1933.II.A. (1933); 4 Taxation of Foreign and National Enterprises (Methods of Allocating Taxable Income) League of Nations Doc. C.425(b).M.217(b).1933.II.A.

At the heart of this consensus was the general notion that in apportioning income among related entities,[17] tax authorities

---

(1933); see Langbein, note 8, at 631-38 (describing the production history of the League of Nations reports).

[17] From the earliest occurrences of debate over transfer pricing, the analysis has been complicated by the need to provide rules not only for pricing among separately incorporated commonly controlled entities (such as the parent and subsidiaries of a typical corporate group), but also among different branches of single legal entities. See, e.g., Langbein, note 8, at 631 (describing complexities introduced by "branch versus entity" issue in early League of Nations discussions in 1920's). The branch pricing issue (described, where bilateral income tax treaties are in force among particular countries, as the issue of pricing transactions among "permanent establishments"), always has posed special problems, particularly in view of the difficulty under common legal perceptions of identifying "transactions" among divisions of a single legal entity, and the difficulties are very much alive today. See, e.g., OECD Launches Consultation With Business, Governments on Attributing Profits to PEs, 10 Tax Mgmt. Transfer Pricing Rep. 994 (Apr. 17, 2002); John P. Warner & Carol P. Tello, Taxing Interbranch Dealings: Application of Separate Taxpayer Arm's Length

should seek to approximate the results that would have obtained if the entities had been unrelated and had been dealing with one another at arm's length. In adopting this approach, the Carroll report rejected a competing model of "fractional" or "formulary" apportionment.[18] Under a formulary approach, the income of businesses operating in multiple taxing jurisdictions is apportioned not according to legal entity boundaries, but instead based on the distribution of various indicators of economic activity (typically tangible property employed in the business, payroll expenses, and sales revenue) in the different taxing jurisdictions.[19]

Principles to Inbound Interbranch Distribution Dealings, 31 Tax Mgmt. Int'l J. 155 (Mar. 8, 2002). While this Article does not attempt to address the many special issues with respect to interbranch pricing, all of the concepts arising in pricing among separate entities also must be addressed, in one form or another, in addressing the pricing problem in a branch context. We therefore hope that the observations made in this Article will prove useful in both the separate entity and interbranch settings.

[18] Langbein, note 8, at 633.

[19] Avi-Yonah, note 8, at 92.

Some states of the United States, and the political sub-units of some other countries with federal systems, had by the early 1900's adopted such systems for their domestic use, as had the countries in some closely related international trading blocs.[20] The authors of the Carroll report, however, concluded that a fractional approach would not be feasible in the international arena, largely because of the difficulty of persuading countries with differing economic interests to agree upon a common apportionment formula, and because of complications introduced by differences in accounting rules.[21]

Beginning with a draft League of Nations Model International Tax Convention in 1935, various model international tax conventions have incorporated different formulations of the separate accounting principle.[22] Similar

---

[20] See generally 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation ch. 8 (3d ed., 2000) (describing history of multistate apportionment in the United States); Langbein, note 8, at 632 (describing apportionment systems used by other federal systems early in the 20th century).

[21] Langbein, note 8, at 633.

[22] See Fiscal Committee—Report to the Council on the Fourth Session of the Committee, League of Nations Doc. C.399.M.204.1933.II.A., at 4 (1933), reprinted in 4 Joint Comm.

language is found in virtually all income tax treaties today.[23] In the United States, in 1935, Treasury adopted the arm's length standard in regulations,[24] which persisted essentially unchanged until 1968.[25] At the heart of these regulations was the statement that "[t]he standard to be applied in every case is

---

on Internal Rev. Tax'n, Legislative History of United States Tax Conventions 4241 (1961) (1935 draft convention); Langbein, note 8, at 633-34 (discussing the Carroll report's reasons for the use of the separate accounting principle).

[23] See, e.g., OECD Model Double Taxation Convention on Income and on Capital, art. 9(1) (2000):

=xt

> Where a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

=ft

[24] Regulations 86 Relating to the Income Tax Under the Revenue Act of 1934, art. 45-1(b) (1935).

[25] See notes 46-67 and accompanying text.

that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."[26]

Despite the apparent consensus in favor of the "arm's length" approach by the mid-1930's, there appears to have been virtually no common understanding in the United States or elsewhere as how to apply the arm's length standard.[27] The lack of precision appears to have reflected the basic fact that, in

---

[26] Art. 45-1(b), note 24, provided in full:

=xt

> *Scope and purpose*.—The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Commissioner shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

=ft

[27] Langbein, note 8, at 640.

the United States as elsewhere in the world, international transfer pricing seems to have been of only small concern to tax authorities. As late as the early 1970's, virtually no legislation addressed the issue outside the United States, and "many . . . countries frankly admitted a wholesale lack of experience with the entire problem . . ."[28]

In the United States, only a handful of cases arose in the 25 years following adoption of the arm's length standard in 1935, and those cases are notable mainly for their inability to articulate any specific methods by which the arm's length standard might apply.[29] In particular, the notion that compliance with the arm's length standard normally should be tested by reference to uncontrolled comparables seems to have been applied only sporadically.[30] While the notion of comparables would seem to arise naturally from the idea of treating transactions among related entities "as if" they were transactions among unrelated parties, most cases were decided without reference to comparables, with decisions based instead on the broad question whether the parties' pricing was, for

[28] Id.

[29] Avi-Yonah, note 8, at 98-107, describes the case law following 1935.

[30] See id. at 98.

example, "fair and reasonable."[31] There appears to have been no feeling of urgency prompting clarification of the arm's length standard, in the United States or elsewhere.

The apparent lack of interest in international transfer pricing may reflect the relative difficulty that corporate management faced, until relatively recently, in pricing intragroup transactions on terms other than those dictated by the market even when they were inclined to do so. Prior to the second half of the 20th century, large multinational groups existed, but the transportation, communications, and data management technologies necessary to operate them in a centralized fashion was far less developed than it has become in more recent years. Managements of even the most forward-looking multinational groups were compelled as a practical matter to

---

[31] Compare, e.g., Seminole Flavor Co. v. Commissioner, 4 T.C. 1215, 1233 (1945) ("transaction would seem to be fair"), and Polak's Frutal Works, Inc. v. Commissioner, 21 T.C. 953, 976 (1954) ("fair and reasonable prices for its services"), with Hall v. Commissioner, 32 T.C. 390, 410 (1959), aff'd, 294 F.2d 82 (5th Cir. 1961) (reference to a comparable price in case involving discounts provided to distributors); see generally Avi-Yonah, note 8, at 98-107 (digesting and comparing judicial opinions).

leave pricing among different components of commonly owned groups to the same self-organizing and self-enforcing market mechanisms that determined pricing among entities that were not commonly controlled. Thus, it seems highly likely that, even among the constituents of commonly controlled groups, market dynamics resulted in natural self-enforcement of a situation tolerably corresponding to widely held notions of "arm's length."[32]

---

[32] The management of a multinational entity may have strong business reasons, entirely unrelated to tax considerations, to price intragroup transactions at other than market prices. In order to do so, however, the group's management must have the ability to make and enforce pricing decisions designed to benefit the interests of the group as a whole, rather than the separate interests of the group's constituents. That is, management must have the practical ability to manage the group in an effectively centralized manner, rather than in effect to delegate the function of determining intragroup prices by permitting separate units to operate largely independently and thus regulate the group's internal affairs through market mechanisms. See generally Michael C. Durst, Management vs. Tax Accounting in Intercompany Transfer Pricing, 10 Tax Mgmt. Transfer Pricing Rep. 909 (Mar. 6, 2002).

Moreover, despite the wave of invention that occurred in the late 19th and early 20th centuries, it is probably fair to conclude that the activities of multinational companies before World War II remained far more tied to physical plant and physical activity, as opposed to easily transported intangible property, than has become the case subsequently. Thus, until fairly recently, movements of income-producing activities, in ways that might have derived advantage from differences in tax rates among jurisdictions, probably appeared infeasible to the management of most multinational groups.

=S2 B. The Revenue Act of 1962: Flirting With Formulas@

Transfer pricing policy first became the focus of serious concern in the United States in the 1960's primarily because of one category of transactions—transfers of business activities, often involving patents and similar intangibles, by U.S. companies to manufacturing and distribution subsidiaries in low-tax jurisdictions. Although transactions of this kind represent only a portion of the transactions entered into globally among members of multinational groups, they historically have been and remain of disproportionately high perceived revenue impact and (as a result) political sensitivity. Perhaps because of the historically greater prominence of U.S.-based multinationals,

such transactions historically have been of greater concern to the United States than to other countries.[33]

The catalysts for this development appear to have included: (1) the prominence of the United States as a capital exporting power following World War II; (2) the emergence of intangible property as a prominent income-generating factor in newly emergent industries, particularly but not exclusively the pharmaceutical industry that was spurred by wartime and post-war technological development; (3) growing familiarity on the part of business managers with policies of some countries that had established low levels of business taxation in order to attract foreign investment,[34] and also with the allowance by the United States of the use of Western Hemisphere trade corporations

---

[33] For example, during the 1960's, 18 of the 20 largest companies in the world were U.S.-based. 1 Nat'l Foreign Trade Council, The NFTC Foreign Income Project: International Tax Policy for the 21st Century 33 (2001), available at http://www.NFTC.org/default.asp?mode=directorydisplay&id=162.

[34] Thus, in 1961 tax proposals, Treasury pointed to "a thriving boom in the use of foreign tax havens. . . ." Stanley S. Surrey, 1961 Tax Proposals, Speech to the Bond Club of Chicago (May 18, 1961), in Selected Speeches and Testimony of Stanley S. Surrey 7, 19 (William F. Hellmuth & Oliver Oldman eds., 1973).

(WHTCs) and other special tax-favored arrangements that invited U.S. companies to perform operations overseas in order to benefit economic development in certain regions;[35] and (4) perhaps, greater emphasis within businesses on techniques of centralized management, which permitted greater control over the operations (including the pricing) of geographically dispersed groups.

By the 1960's, the Service had greatly stepped up its scrutiny of intragroup transfer pricing,[36] and numerous transfer pricing controversies came to the attention of the courts. These controversies typically involved alleged outbound shifts of income from U.S. taxing jurisdiction,[37] often involving the

---

[35] Cf., e.g., Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates and Gifts ¶¶ 68.1.2, 67.3 (2d ed. 1991 & supp. 2003) (describing histories of special tax rules relating to investment in Puerto Rico, and to WHTCs).

[36] See generally Walter Treumann, Recent IRS Audits of Foreign Operations, 40 Taxes 788 (1962).

[37] The only prominent international transfer pricing case of the 1960–1990 period not involving an outbound transfer was Ciba-Geigy Corp. v. Commissioner, 85 T.C. 172 (1985), and that case, while involving an inbound transfer of intangibles, also involved the payment of royalties to Switzerland, which had long

license of patents to affiliates organized in low-tax jurisdictions or operating under favorable rules provided under U.S. law.[38]

Spurred by perceived difficulties in addressing outbound transfers of U.S. business activities through enforcement based

---

been high on Treasury's list of tax haven jurisdictions. See S. Rep. No. 87-1881, at 78 (1962), reprinted in 1962-3 C.B. 707, 784 (quoting the President as having referred to Switzerland as a "tax haven").

[38] Avi-Yonah, Rise and Fall, note 8, at 103-11, describes the cases of the 1960's and early 1970's that resulted from the post-1960 IRS enforcement push. Prominent cases included United States Gypsum Co. v. United States, 304 F.Supp. 627 (N.D. Ill. 1969), aff'd in part and rev'd in part, 452 F.2d 445 (7th Cir. 1971) (shipping fees paid to Panamanian subsidiary and pricing of goods with a WHTC); PPG Industries, Inc. v. Commissioner, 55 T.C. 928 (1970) (sales to Swiss marketing subsidiary); Ross Glove Co. v. Commissioner, 60 T.C. 569 (1973) (Bahamian sales and manufacturing entity); Eli Lilly & Co. v. Commissioner, 372 F.2d 990 (Ct. Fed. Cl., 1967) (involving sales to a WHTC). The last was the first of several prominent cases involving pharmaceutical companies that were to play prominent roles in shaping U.S. transfer pricing law.

on reference to uncontrolled comparables, the House of Representatives, in the bill that eventually became the Revenue Act of 1962, proposed a "formulary" approach similar to that used for multistate income apportionment in the United States. The Ways and Means Committee Report expressed the view that the pricing of goods between U.S. corporations and foreign subsidiaries had tended "to understate the taxable income of the domestic corporation subject to U.S. tax and to overstate the income of the foreign subsidiary,"[39] and that existing rules forced Treasury into impracticable attempts to enforce the arm's length standard by reference to an intractable volume of transactional pricing information.[40] The House bill therefore would have granted Treasury the power to prescribe formulas for apportioning income from dealings in tangible property among affiliates, based generally on the location of assets, compensation expenses, and marketing and advertising expenses, when no comparable uncontrolled prices were available.[41]

---

[39] H.R. Rep. No. 87-1447, at 28 (1962), reprinted in 1962-3 C.B. 405, 432.

[40] Id.

[41] The Ways and Means Committee described the House provision as follows:

=xt

Under the general allocation rule provided by the bill the Secretary or his delegate is to allocate the income between the United States organization and the foreign organization on the basis of the proportion of the assets, the compensation of officers and employees and the advertising, selling and sales promotion expenses of the group which on one hand are not attributable to the United States and which on the other hand are attributable to the United States. For this purpose, only those assets, that compensation and those sales, etc., expenses which are attributable to the property so sold or purchased are to be taken into account.

The allocation need not be based upon the above-mentioned factors alone. The provision specifically authorizes the inclusion of other factors such as special risks, if any, of the market in which the product is sold. In addition, if the taxpayer or the Secretary or his delegate can work out some other mutually agreeable method of allocating income, this alternative method is to be used instead of the rule referred to above.

=ft

Id. at 34.

It is noteworthy that the House bill provided for apportionment only of income derived from transfers of tangible property, not of intangibles. The reason might lie in a Committee's perception that reliable comparables could more readily be found for the relatively small number of intangibles licenses transacted in a given year than the much larger number of transactions in comparables. The limitation also might reflect the particular political sensitivity that already, by 1962, attended the topic of outbound transfers of intangibles.

Business groups reacted vehemently to the House proposals, pointing primarily to what they described as the bill's greatly excessive grant of discretionary authority to enforcement officials.[42] A number of factors may have influenced industry

---

[42] Revenue Act of 1962, Hearings on H.R. 10650 Before the Senate Finance Comm., 87th Cong. 3505 (1962). A wide variety of industries and business groups testified. A representative comment is that of the American Chamber of Commerce of Venezuela:

=xt

> Through the establishment of a few vague, arbitrary, and mechanical rules, it apparently is hoped to apply the same or similar bases to all taxpayers in the allocation of income. However, because of the infinite variety of situations among businesses abroad, taking into account the distinct laws of foreign governments, labor policies, risks, customs, and so forth, it is virtually impossible to lay down general rules to be applied to all taxpayers in connection with allocation of income. We believe application of the rules in this section would result in inequities and hardships and involve taxpayers in endless disputes with the Treasury, which would be costly and time consuming for all concerned.
>
> Unfortunately, it appears that the proposed section would encourage the Treasury to allocate income in the manner which results in the most tax, regardless of whether or not the resulting allocation is reasonable or realistic in the light of all the circumstances. Moreover, the Treasury is not bound to be consistent in its treatment of all taxpayers, or even the same taxpayer from one year to the next; and in all cases in defending his position the burden of proof would rest with the taxpayer.

reaction, including what fairly must be described as the only sketchily developed description of the proposal provided by the House.[43] It also must be acknowledged, however, that some of the resistance might have resulted from the perceived revenue implications of the House proposal. The House did not disguise its view that the proposed formulary approach would provide the Service with tools that would permit more vigorous enforcement. By 1962, the use by U.S.-based companies of business structures involving transactions with controlled entities in low-tax jurisdictions apparently had become widespread and routine. The

---

=ft

Id. at 4004.

[43] See id. at 3691 (statement of Pharmaceutical Manufacturers Association) ("We can conclude only that this provision was . . . hastily drafted because the formulas are unworkable, the bookkeeping requirements are immense, and the administrative problems are insurmountable."); cf. Joseph H. Guttentag, Passing the Torch on Transfer Pricing 2 (paper prepared for presentation to London Meeting of International Fiscal Association) (Dec. 2000) (unpublished manuscript on file with the Tax Law Review) ("There was a firestorm of protest from the business community charging, with much soundness, that the results would be quixotic and arbitrary").

House proposal of a formulary approach, which was designed explicitly to facilitate a tightening of IRS enforcement, threatened to amount to a substantive tax increase on a wide range of U.S. businesses.

The Senate and the Conference Committee dropped the formulary provision from subsequent versions of the legislation. The Revenue Act of 1962, while introducing to the Code far-reaching rules designed to limit the ability of U.S. companies to defer U.S. taxation of income earned by subsidiaries engaged in certain kinds of activities outside the United States,[44] left then-existing transfer pricing rules unchanged. The Conference Report, however, directed Treasury to re-examine its existing regulations, in language suggesting that Congress envisioned a potentially far-reaching revision—specifically mentioning the

---

[44] The 1962 legislation enacted the first version of the controlled foreign corporation (CFC) rules of subpart F of the Code, which generally require the immediate inclusion of certain income earned by the foreign subsidiaries of U.S. corporations in situations in which the activities of those subsidiaries are considered insufficiently substantial to permit deferral of U.S. taxation. See Revenue Act of 1962, Pub. L. No. 87-834, § 12, 76 Stat. 960, 1006.

possibility of "guidelines and formulas for the allocation of income and deductions."[45]

=S2 C. The 1968 Regulations: Comparables Enshrined@

The regulatory effort that followed Congress' invitation in 1962 commanded high-level attention within Treasury,[46] and

[45] The Conference Report said:

=xt

> The conferees on the part of both the House and the Senate believe that the objectives of Section 6 of the bill as passed by the House can be accomplished by amendment of the regulations under present section 482. Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate income and deductions. It is believed that the Treasury should explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.

=ft

H.R. Rep. No. 87-2508, at 18-19 (1962), reprinted in 1962-3 C.B. 1129, 1146.

[46] The project was of obvious personal interest to then-Assistant Secretary of the Treasury Stanley Surrey. See Stanley S. Surrey, Treasury's Need to Curb Tax Avoidance in Foreign Business Through Use of 482, 28 J. Tax'n 75 (1968) [hereinafter Use of 482]; Stanley S. Surrey, Reflections on the Allocation of

required close to six years to complete. The resulting 1968 regulations represented an almost complete rejection of the invitation to consider the adoption of formulas,[47] and instead consisted almost entirely of guidelines. These guidelines consisted mainly of the articulation of transfer pricing methods to be used in different circumstances, generally based on information to be derived from uncontrolled comparable transactions.[48]

The 1968 regulations established three methods intended to be used to evaluate the arm's length nature of intercompany transfers: (1) a "comparable uncontrolled price" method, envisioned to be used in connection with transfers of intangible as well as tangible property, and under which the arm's length nature of the price used in the intragroup transaction was to be based on direct comparison with the prices used in transfers of "similar" property, under "similar" circumstances, between

---

Income and Expenses Among National Tax Jurisdictions, 10 Law & Pol'y Int'l Bus. 409 (1978).

[47] But cf. the limited allowance of safe harbors described in notes 53-56 and accompanying text.

[48] See Surrey, Use of 482, note 46, at 75-78 (repeatedly referring to regulations as articulating "guidelines").

unrelated parties;[49] (2) a "cost-plus" method, envisioned typically to be applied to prices charged by manufacturing affiliates in sales of tangible property to related distributors, and under which the manufacturer would be expected to earn a percentage gross markup on costs equivalent to the markup observed in "similar" manufacturing operations;[50] and (3) a "resale price" method, under which a distributor that purchased property for resale from a manufacturing arm of its multinational group would be expected to earn a percentage gross resale price margin equivalent to the margins enjoyed from the purchase and resale of "similar" products, under "similar" circumstances, from an unrelated manufacturer.[51]

While the regulations apparently anticipated that in most circumstances encountered by tax examiners, it would be feasible to identify the comparable transactions needed to apply the newly prescribed methods, they also envisioned that in some circumstances it would not be possible to identify the necessary comparables. In those circumstances, the regulations provided very broadly that the examiners could fashion their own methods, which became known among tax practitioners as "fourth methods,"

---

[49] Reg. § 1.482-2(e)(2) (1968).

[50] Reg. § 1.482-2(e)(4) (1968).

[51] Reg. § 1.482-2(e)(3) (1968).

in order to evaluate the arm's length nature of a taxpayer's controlled transactions.[52] The regulations, however, did not specify particular formulas or other devices to be applied in connection with fourth methods.

Several features of the 1968 regulations departed somewhat from their overall emphasis on comparables. First, the regulations provided safe harbors designed to eliminate the need to identify and apply uncontrolled comparable transactions in some circumstances. These safe harbors prescribed interest rates that could be used for intercompany loans,[53] and also delineated situations involving the provision of certain incidental management and support services within multinational groups in which a simple reimbursement of costs without a profit element would be deemed appropriate compensation.[54] The 1968 regulations also offered a safe harbor, based on depreciation allowances and market rates of return, designed to eliminate the

---

[52] Reg. § 1.482-2(e)(1)(iii) (1968) ("Where none of the three methods of pricing described . . . can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described . . ., or variations on such methods, can be used.").

[53] Reg. § 1.482-2(a)(2) (1968).

[54] Reg. § 1.482-2(b)(3),(4) (1968).

need for reference to comparables in determining arm's length rental rates for the use of tangible property,[55] although this safe harbor attracted little attention and later was eliminated in a technical redrafting of the safe harbor rules.[56]

In addition to their limited allowance of safe harbors, the 1968 regulations provided for a departure from the comparables-based approach and contained the seeds of a fundamentally different model of arm's length pricing. The 1968 regulations acknowledge the legitimacy, under the arm's length standard, of cost-sharing agreements, under which different entities agree jointly to share the risks of developing specified categories of intangible property, in return for shares of the rights to exploit any property developed under the agreements.[57] The notion of cost sharing seems to have derived from longstanding tax rules in the United States under which mineral extraction companies could pool the costs of developing mineral properties

[55] Reg. § 1.482-2(c)(2)(ii) and (iii) (1968).

[56] The technical amendment occurred in 1988, when Treasury amended the safe harbor for interest rates to conform to recently adopted rules specifying interest rates for transactions involving original issue discount. T.D. 8204, 1988-1 C.B. 246.

[57] Reg. § 1.482-2(d)(4) (1968).

and could share the output of those properties, without thereby being deemed to have created a separate entity for tax purposes.[58]

There is some evidence that Surrey viewed cost sharing as a potentially valuable conceptual template that could be used to alleviate compliance concerns on a global basis, as he actively encouraged other governments to adopt the notion.[59] Perhaps,

---

[58] Although the early history of cost sharing is obscure, oil companies apparently were among the earliest users of the concept, which bears striking similarity to the notion under U.S. tax law of joint operating agreements for the development of mineral properties. Cf. Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 2.05[1] (7th ed. 2000) (describing U.S. rules under which joint operating arrangements will not give rise to separately taxable entities); Brian J. Arnold & Thomas E. McDonnell, Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries, 7 Tax Notes Int'l 1507 (Dec. 13, 1993) (describing use of cost sharing by oil companies).

[59] Surrey, Use of 482, note 46, at 78 ("We have discussed cost sharing with representatives of foreign governments, attempting to impress upon them the need for such a system and the fact

however, because of limited interest in transfer pricing issues generally outside the United States, his appeal drew little attention, and cost sharing does not appear to have had much prominence in public discussion in the period immediately following the 1968 regulations. In recent years the topic has become much more prominent, and the notion of cost sharing does indeed include concepts of potentially broad application.[60]

Despite their limited allowance of safe harbors and their recognition of cost sharing, the 1968 regulations are notable primarily for their adoption of the now-familiar pattern of applying the arm's length standard based on "uncontrolled comparables," and on specifying "transfer pricing methods" for applying data from comparables in particular situations. This resolution might appear surprising, in light of the facts that (1) the congressional impetus for the regulations had been a perceived need for more effective enforcement tools; (2) as evidenced by the history of the 1962 Act, formulary apportionment was perceived as likely to facilitate easier enforcement; and (3) Congress had explicitly invited Treasury to consider formulas, as well as guidelines, in drafting

---

that in most cases it would result in smaller inter-company charges than would otherwise be required.").

[60] See notes 213-219 and accompanying text. **[x]**

regulations. One might have expected the pre-1968 Treasury to have been leading a charge toward formulary apportionment.

A number of reasons probably contributed to Treasury's aversion to formulas in the 1968 regulations. Much of the underlying concern undoubtedly was substantive. The 1962 debate had exposed numerous technical difficulties with a formulary approach, and the 1962 reaction had shown the danger inherent in insufficiently refined formulary proposals. The overall political hostility shown in 1962 to the formulary notion also must have given Treasury pause. In addition, the case law since 1962 generally can be characterized by judicial movement toward a comparables-based system and away from a more subjective "fair and reasonable" interpretation of the arm's length standard.[61] Treasury may have been unwilling to sacrifice gains that it perceived from the courts' growing emphasis on reliance on comparables, in exchange for a possibly quixotic attempt to impose a system of formulary apportionment.

A striking aspect of the 1968 regulations is the high level of factual detail that they expected tax authorities to take into account in determining whether particular comparables were sufficiently reliable to support application of the new methods. In general, the regulations seem to have endeavored to list as

[61] Avi-Yonah, note 8, at 98-107.

many factors as they could articulate that, in an actual market setting, might affect the determination of price. Given the virtually infinite complexities of actual markets, the lists provided in the regulations therefore are long.[62]

[62] Thus, for example, in describing the comparable uncontrolled price method, § 1.482-2(e)(2)(ii) of the 1968 regulations provided:

=xt

> Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved.

=ft

Similarly, in describing the resale price method, § 1.482-2(e)(3)(vi) provided:

=xt

> The following are the most important characteristics to be considered in determining the similarity of resales:
> (a) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances.
> (b) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor assembly, advertising, selling at wholesale, selling at retail, billing, maintenance of accounts

Absent, however, was any consideration of how, in the context of actual tax examinations, revenue agents might effectively assemble and weigh the relevant facts. This absence does not seem to have been of significant public concern at the time; nevertheless, one prominent commentator expressed the following view, which in light of subsequent events appears notably prescient:

=xt

> The first question that arises after a close reading of the proposed section 482 regulations is how much simplicity and reduction of uncertainty will be effected thereby. Their constant references to all facts and circumstances and the numerous valuation complexities created by the various formulas contained therein, bode ill for ease of administration hopes. Moreover, the incredible mass of detail contained in the proposed regulations, coupled with their almost equally consistent retreats to vaguely worded general principles, tends to weaken the cohesive structure of these provisions. The net effect of the regulations seems more likely, on balance, to increase rather than decrease disputes under section 482. It may well be that the new proposals, despite their general readability, just cannot be effectively applied to concrete situations in practice. In any event, the corpus of the law under section 482 is fast approaching that of the consolidated returns area in

---

receivable, and servicing.
(c) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names.
(d) The geographic market in which the functions are performed by the reseller.

=ft

size, scope, and complexity.[63]

=ft

The 1968 regulations also lack any reference to the possible significance for transfer pricing purposes of contractual arrangements that might be made among related entities.[64] The market prices of virtually all transactions depend on their contractual terms—for example, who is to bear the risk that products or services will prove defective, for how long a supplier will commit to making a product available or a seller to purchasing the product, and so on virtually ad infinitum. It is, as a practical matter, impossible to analyze transactions in the degree of detail that the 1968 regulations envisioned, without making reference to the contractual arrangements underlying the transactions.

---

[63] James S. Eustice, Tax Problems Arising From Transactions Between Affiliated or Controlled Corporations, 23 Tax L. Rev. 451, 517 (1968).

[64] For a discussion of the now widespread use of intercompany agreements, see generally Michael C. Durst, The Role of Intercompany Contracts in the Transfer Pricing System, 90 Tax Notes 513 (Jan. 22, 2001); cf. David G. Harris & Richard C. Sansing, Distortions Caused by the Use of Arm's-Length Transfer Prices, J. Am. Tax'n Ass'n, Supp. 1998, at 40.

The 1968 regulations, however, avoided any implication that governmental authorities should give deference to contractual arrangements among commonly controlled entities. The regulations imply instead that the "circumstances" of intragroup transactions are to be evaluated only on an ex post basis, by reference to the parties' actual behavior ("functions"). No mention is made of any arrangements that might have been memorialized on an ex ante basis.[65] Perhaps the drafters

---

[65] Thus, for example, § 1.482-2(e)(2)(ii) of the 1968 regulations acknowledges that prices for sales made in large volumes typically will differ from prices for sales made in smaller volumes, but the regulation does not mention the likelihood that commitments to sell in particular volumes typically in practice will be established contractually in arm's length transactions. Similarly, while the same portion of the 1968 regulations refers to the importance of "terms of sale," the context suggests strongly that the drafters are referring to determinations of terms that are made ex post, based on transactions that actually were concluded, rather than "terms" set forth in an ex ante agreement. Even the safe harbor interest rate for intragroup loans envisions that all such loans will be of a single assumed maturity, thus avoiding the need to give reference to the terms stated in intragroup agreements. Cf. § 1.482-2(a) (1968).

believed that ex ante agreements between related parties are so subject to manipulation as to be devoid of evidentiary value. The drafters also may have envisioned that tax authorities would have at their disposal ample ex post evidence to use in evaluating parties' intended apportionments of functions and risks without the need to refer to ex ante agreements.

The regulations' lack of reference to the notion of ex ante agreement among commonly controlled entities also may reflect an understandable lack of familiarity with the behavior of commonly controlled entities which, in the mid-1960's, had made their way only recently into the economic literature. The drafters probably expected that the natural tendency of integrated groups of companies, in the absence of a tax avoidance motivation, would be to effect intragroup transactions at arm's length prices. By the mid-1960's, however, as experience with the

---

Although Treasury changed that approach after the Tax Reform Act of 1984, by adopting as safe harbor rates the different applicable federal rates established under the Code's original issue discount rules for obligations of differing maturities, see T.D. 8204, 1988-1 C.B. 246, in particular Reg. § 1.482-2(a)(2)(iii), the single maturity approach taken in 1968 suggests a desire to avoid reliance on ex ante intragroup agreements.

operations of integrated economic groups grew, economic analyses had shown that expectation to be incorrect.

In fact, the more integrated a commonly controlled group becomes, the greater the pressure will be to price transactions at cost, not at market levels, for reasons unrelated to taxation.[66] Thus, the management of a multinational group, if it wants to ensure pricing at the arm's length levels required by the tax law, typically must adopt special measures to do so. If only in order to provide employees with a written reference in order to permit compliance as an operational matter, such measures usually involve written memorialization of the price regime to be used. The absence in the 1968 regulations of reference to the potential evidentiary value of intragroup agreements therefore reflects not only a high level of confidence in the predictability of ex post factual determinations; it also shows that governmental perceptions, as of 1968, had not yet incorporated the implications of the economic literature relating to the behavior of integrated economic groups.[67]

---

[66] Jack Hirshleifer, On the Economics of Transfer Pricing, 29 J. Bus. 172 (1956); see generally Durst, note 64, passim.

[67] This literature received increasing attention in subsequent decades. However, even the most recent compilations of transfer

In any event, the 1968 regulations comprised overall a strong statement of the principle that tax authorities should seek to enforce the arm's length standard through retrospective analysis based on comparables. Moreover, the issuance of the regulations coincided with what appeared at the time to be a definitive judicial adoption of the view that reference to comparables, as opposed to a "reasonableness" standard, constituted the proper basis of enforcement under the arm's length standard. Thus, the years following the 1968 regulations provided a definitive practical test of a system of enforcement based on comparables.

=S2 D. The Post-1968 Case Law: Ascendancy of Economic Experts@

In the years following their promulgation, the effectiveness of the regulations was tested in a number of prominent cases, many of which involved large amounts of tax liability. Several available analyses describe the post-1968 cases in careful and thoughtful detail.[68] Each case had, of

---

pricing guidance do not address these topics squarely. See notes 107-113 and accompanying text. **[x]**.

[68] E.g., Reuven S. Avi-Yonah, Analysis of Judicial Decisions Interpreting § 482, in Transfer Pricing: Judicial Strategy and Outcomes, 888 Tax Mgmt. Portfolio (BNA) A-101 (1995); Treasury

course, its unique factual and judicial background, and it is difficult to distill consistent legal principles. Nevertheless, certain patterns are apparent.

First, the overwhelming majority of the cases involved the familiar fact pattern of outbound migration of business activities that had originated in the United States.[69] Moreover, although exceptions exist,[70] a large proportion of the cases involved either technologically intensive industries in which much of the income-generating potential can be attributed to readily identifiable intangibles, or mobile sources of activity, such as shipping or management services. Cases outside these factual settings seem to have elicited little enforcement controversy. Similarly, tax authorities outside the United

---

Dep't, A Study of Intercompany Pricing Under Section 482 of the Code, reprinted as Notice 88-123, 1988-2 C.B. 458, 466-68 [hereinafter "White Paper"].

[69] The only inbound case of note appears to have been Ciba-Geigy v. Commissioner, 85 T.C. 172 (1985). See note 37.

[70] See, e.g., United States Gypsum v. Commissioner, 304 F. Supp. 627 (N.D. Ill. 1969), aff'd in part and rev'd in part, 452 F.2d 445 (7th Cir. 1971); Cadillac Textiles Inc. v. Commissioner, 34 T.C.M. (CCH) 295 (1975).

States continued to show little interest in transfer pricing issues of any kind.[71]

Second, as a general matter, the government fared poorly in these cases, with the government's record deteriorating steadily as time elapsed after 1968, culminating in a string of stinging defeats during the 1980's and early 1990's.[72] Virtually none of

---

[71] In 1979, the OECD issued a report on transfer pricing that largely restated the content of the 1968 U.S. regulations. OECD Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises (1979). The OECD deliberations that led to these guidelines seem to have been a slow-moving and low-profile response to the U.S. regulations, apparently initiated by the U.S. Treasury, and the 1979 Report seems to have been of limited international significance. See Guttentag, note 43. **=fb [DS: Cited source does not support.] =fn**

[72] Avi-Yonah, note 8, at 112-29, citing especially Hospital Corp. of America v. Commissioner, 81 T.C. 520 (1983) (transfer of hospital management business to Cayman Islands company); Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part and remanded, 856 F.2d 855 (7th Cir. 1988) (transfer of pharmaceutical patents to Puerto Rico subsidiary); G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987) (transfer to Puerto Rico subsidiary); *Ciba-Geigy Corp.*, 85 T.C. at 172

these cases ultimately was decided by reference to comparables. Instead, the comparables offered by one side generally could be dismissed easily based on arguments offered by the opposing party.[73] The courts therefore generally determined themselves

---

(payment of royalty to non-U.S. parent); Sundstrand v. Commissioner, 96 T.C. 226 (1991) (license of aircraft manufacturing technology to Singapore subsidiary); Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525 (1989), aff'd, 933 F.2d 1084 (2d Cir. 1991) (license of soft contact lens manufacturing process to Irish subsidiary).

[73] An interesting exception is United States Steel Corp. v. Commissioner, 617 F.2d 942 (2d Cir. 1980), in which the appeals court rejected the Tax Court's decision that certain comparables offered by the taxpayer, for shipping fees paid to a Liberian subsidiary, were insufficiently exact to permit their use under the 1968 regulations. Some elements of the Second Circuit's opinion suggest the view that if courts were to subject potential comparables to the high level of review that the Tax Court had applied to the taxpayer's comparables in *United States Steel*, the 1968 regulations as a practical matter could not be implemented. See, e.g., id at 950:

=xt

> [The statute does not] require that *all* independent transactions be at the price taxpayer charged or paid;

bound to apply fourth methods of the courts' own reluctant devising.[74] Generally, these methods involved approximate determinations of the "reasonable" returns to be earned[75] by a given distribution or manufacturing arm of the multinational

---

> . . . Since there were independent transactions significant in number and dollar amount and occurring over a long period of time, we need not address the question of how many such "independent transactions" at the taxpayer's price would be needed to insulate taxpayer from § 482 in a situation where a preponderance of the "independent" transactions take place at a price far different from the price paid or charged by taxpayer.

=ft

[74] See Seagate Technology, Inc. v. Commissioner, 102 T.C. 149, 195-96 (1994) (rejecting the CUP, resale price, and cost-plus methods and deciding that a markup of 20% was appropriate); see also National Semiconductor Corp. v. Commissioner, 67 T.C.M. (CCH) 2849, 2873-75 (1994) (adopting a modified "transactional analysis"); Perkin-Elmer Corp. v. Commissioner, 66 T.C.M. (CCH) 634, 657 (1993) (finding a "middle ground" between parties' formulas); *Sundstrand*, 96 T.C. at 375 (concluding that different methods should have been used for different categories of products, and making "best estimate" of a transfer price).

[75] See generally E.I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979) (upholding Service's use of a fourth method because it produced a reasonable result).

group under consideration, or "reasonable" percentages by which different parties to controlled transactions might "split" their combined profits.[76]

A striking element of the cases is the often extreme length of the resulting opinions—sometimes much more than 100 pages in the official printed reports[77]—and the apparently huge resources expended by both sides. In many cases, the expert testimony plainly required months of preparation by prominent economists and senior members of the tax bar. Another striking element is the frequency of undisguised statements of irritation by the judges concerned, both in the pages of the judicial opinions themselves[78] and in commentary directed toward the goal of law

---

[76] See generally *Eli Lilly & Co.*, 84 T.C. at 996; *Hospital Corp. of Am.*, 81 T.C. at 520.

[77] See, e.g., *Eli Lilly & Co.*, 84 T.C. at 996 (196-page Tax Court decision); *Sundstrand*, 96 T.C. at 226 (185-page Tax Court decision).

[78] For example, in *Sundstrand*, 96 T.C. at 374-75, Judge Hamblen said on behalf of the court:

=xt

> [W]e must say that our attempt to determine an appropriate arm's-length price . . . to a large extent has been stymied by the poor state of the record in this case. We found the record to be one more of obfuscation than of enlightenment. The complexity of our task was exacerbated by the contentiousness of the

reform.[79] The record of these disputes can be read as having turned transfer pricing enforcement into little more than a

---

> parties. They at times seemed to be antagonists rather than adversaries.
>
> . . . .
>
> . . . It is obvious to us that we were too tolerant with the parties during the pretrial proceedings.
>
> However, we must determine the appropriate arm's-length consideration . . . on the record before us. Our task was not easy but we have shouldered the yoke, and the parties now must reap what they have sowed.

=ft

Similarly, in *Hospital Corp. of Am.*, 81 T.C. 520, 596 (1983), the court said, "Unfortunately, there is little quantitative evidence in this record upon which we can determine what a reasonable allocation of profits would be. Neither party has been particularly helpful to the Court in this regard. However, we must do the best we can with what we have."

[79] Judge Tannenwald said in 1994:

=xt

> Unfortunately, in the significant section 482 cases which have confronted the Tax Court in recent years, each party has spent most of the time attacking the other party's allocation formula rather than establishing the soundness of its own formula. Thus, in the final analysis, the judge is left to his or her own devices without the usual anchor of decision, namely that the deficiency is sustained because the taxpayer has failed to carry its burden of proof. The judge must construct a formula, without the benefit of

judicial and economic test of endurance, in which the winner was determined more by the exhaustion of the other side than by the technical superiority of the victor's performance.[80]

> sufficient help from the parties as to what that formula might be. This is a task that requires the Tax Court to find a middle ground, a task which it has disavowed in another context, and one which is most difficult to perform in light of the judge's level of knowledge of the workings of a specific industry.

=ft

Theodore Tannenwald, Jr., Tax Court Trials: An Updated View From the Bench, 47 Tax Lawyer 587, 596 (1994) (footnotes omitted).

[80] Apparently, the very large scale of disputes continues. See Glenn R. Simpson, Glaxo in Major Battle With IRS Over Taxes on Years of U.S. Sales, Wall St. J., June 11, 2002, at A1. The article describes a pending dispute between the Service and GlaxoSmithKline over the apportionment of income from high-value pharmaceutical intangibles. "The case grew out of an IRS audit that began in 1992, but it has become so massive and complex that neither side expects a trial for at least three more years, and possibly not until 2006." The article describes, among other things, procedural issues arising from the advancing age of key potential witnesses.

In January 2004, GlaxoSmithKline PLC announced that it planned to file a petition in the Tax Court involving

The general atmosphere of dysfunction (which one commentator has described as an "audit and litigation nightmare" [81]) extended not only to the judicial but also the administrative process. Apparently, the difficulty both sides of examinations had in identifying comparables with a high degree of persuasive value put the tax professionals in the position of attempting to support their positions without readily available standards for determining appropriate resolutions. Faced with such uncertainty, both sides tended to state relatively extreme positions in the hope of giving themselves room for subsequent negotiation. One result was the often-noted tendency for IRS appeals officers to reduce dramatically the level of adjustments originally proposed by examiners. According to a study by the General Accounting Office, during the period 1987 through 1989, of the transfer pricing adjustments originally proposed, more than 70% were eliminated in the course of subsequent administrative review; in seven of the eight largest cases

---

approximately $5 billion in contested taxes and interest. Susannah Rodgers, Wall St. J., Jan. 8, 2004, at A8.

[81] Avi-Yonah, note 8, at 147.

during this period, the rate of administrative reversal was higher than 85%.[82]

=S2 E. Congressional Action in the 1980's: The "Commensurate With Income" Rule@

By the mid-1980's, many policymakers expressed the view that the 1968 regulations afforded the Service insufficient ability to restrain the expatriation of income from the U.S. tax base, particularly through outbound transfers of intangibles. In 1982, Congress took what can be seen as preliminary steps to address the issue by enacting rules designed to give the Service greater access to information maintained outside the United States.[83] In 1982, Congress also took the additional steps of adopting a form of formulary apportionment for transfer pricing between U.S. companies and subsidiaries operating on a tax-favored basis in Puerto Rico,[84] and in 1984 severely limited the

[82] General Accounting Office, GAO/GGD 92-89, International Taxation Problems Persist in Determining Tax Effects of Intercompany Prices 30 (1992), available at http://www.gao.gov.

[83] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 338, 96 Stat. 324, 631.

[84] Id. § 213, 96 Stat. at 452-63 (adding IRC § 936(h)).

tax-free transfer of intangible property from the United States under corporate tax rules.[85]

The Tax Reform Act of 1986[86] provided an occasion for Congress to look comprehensively at all aspects of the income tax, and transfer pricing received extensive consideration. As in 1962, the House of Representatives initiated the examination of transfer pricing rules.[87] The Senate did not offer a provision of its own although the Conference Committee ultimately adopted the House provision largely unchanged.[88]

The Ways and Means Committee report focused almost exclusively on perceived abuses connected with the transfer of valuable intangible property from the United States. The report explicitly labeled existing transfer pricing rules as inadequate, taking the view that companies were consciously relying on those rules to facilitate tax avoidance,[89] and in

---

[85] Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 131, 98 Stat. 494, 663-64 (amending IRC § 367(d)).

[86] Pub. L. No. 99-514, 100 Stat. 2085.

[87] H.R. Rep. No. 99-426, at 424 (1985), reprinted in 1986-3 C.B. (vol. 2) 424.

[88] H.R. Conf. Rep. No. 99-841, at II-637, reprinted in 1986-3 C.B. (vol. 4.) 637.

[89]
=xt

particular that companies were in some circumstances using the pricing in allegedly comparable transactions as "safe harbors" for prices charged in transactions that were fundamentally different.[90] In addition, and most strikingly, the Committee report endorsed the view that the conceptual model on which the existing regulations were based, of related entities behaving in a manner similar to that of unrelated entities transacting at

---

> The problems are particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may transfer such intangibles to foreign related corporations or to possession corporations at an early stage, for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently take the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items.

=ft
H.R. Rep. No. 99-426, note 87, at 424.

90

=xt

> Certain judicial interpretations of section 482 suggest that pricing arrangements between unrelated parties for items of the same apparent general category as those involved in the related party transfer may in some circumstances be considered a "safe harbor" for related party pricing arrangements, even though there are significant differences in the volume and risks involved, or in other factors. See, e.g., United States Steel Corporation v. Commissioner, 617 F.2d 942 (2d Cir. 1980).

arm's length, might be insufficiently realistic to serve as the basis for a tax enforcement system.[91]

The Committee apparently did not believe, however, that the proper means to address these perceived difficulties was to replace the system established in the 1968 regulations with a formulary approach such as the one passed by the House in 1962. Instead, the Committee proposed the limited step of adding a requirement to § 482 "that payments with respect to intangibles that a U.S. person transfers to a related foreign corporation or possessions corporation must be commensurate with the income attributable to the intangible."[92] The Committee made clear that the primary intent of the change was to permit the Service, in the case of transfers of intangible property, to base adjustments to royalty rates on the amount of income actually generated by a licensed intangible, notwithstanding that the

---

=ft

Id.

[91] Id. (footnote omitted) ("A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. Observers have noted that multinational companies operate as an economic unit, and not 'as if' they were unrelated to their foreign subsidiaries.").

[92] Id. at 425.

level of income to be derived may not have been known at the time of the license or other transfer.[93]

Despite the arguably radical step represented by the commensurate-with-income rule, the Committee seems to have envisioned that transfer pricing examinations would continue to be governed by the factually intensive approach set forth in the 1968 regulations. In particular, the Committee indicated that it did not intend a standard under which a licensee would be permitted to earn only a limited, "risk-free" level of income, with any remaining income remitted to the licensor as a royalty, as the Service recently had argued unsuccessfully to the Tax Court in *Eli Lilly*.[94] Nevertheless, even while expressing

---

93

=xt

> The Committee does not intend . . . that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The Committee intends that consideration also be given the actual profit experience realized as a consequence of the transfer. Thus, the Committee intends to require that the payments made for the intangible be adjusted over time to reflect changes in the income attributable to the intangible. The bill is not intended to require annual adjustments when there are only minor variations in revenues. However, it will not be sufficient to consider only the evidence of value at the time of the transfer. Adjustments will be required when there are major variations in the annual amounts of revenue attributable to the intangible.

=ft

continued commitment to a “facts and circumstances” approach, the Committee’s language suggests that it envisioned a greater role in the examination process for retrospective economic second guessing of parties’ intragroup arrangements than the drafters of the 1968 regulation probably envisioned.[95]

Id. at 425-26.

[94] Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985); see Avi-Yonah, note 8, at 124-25. The Committee said that “the bill does not intend to mandate the use of the ‘contract manufacturer’ or ‘cost-plus’ methods of allocating income or any other particular method.” H.R. Rep. No. 99-426, note 87, at 426.

[95]

=xt

> As under present law, all the facts and circumstances are to be considered in determining what pricing methods are appropriate in cases involving intangible property, including the extent to which the transferee bears real risks with respect to its ability to make a profit from the intangible or, instead, sells products produced with the intangible largely to related parties (which may involve little sales risk or activity) and has a market essentially dependent on, or assured by, such related parties’ marketing efforts. However, the profit or income stream generated by or associated with intangible property is to be given primary weight.

=ft

H.R. Rep. No. 99-426, note 87, at 426.

The Conference Committee adopted, and Congress enacted, the House's commensurate-with-income provisions essentially without change.[96] The Conference Report, however, added language indicating a view that the commensurate–with–income rule might properly be applied in inbound as well as outbound situations.[97] In addition, the Conference report, in an echo of Congress' action in directing a review of transfer pricing regulations in 1962, directed the Service to perform a comprehensive study of intercompany pricing rules, in which "careful consideration should be given to whether the existing regulations could be modified in any respect."[98] The Conference Committee did not provide additional parameters for the study, except to specify that the law should continue to allow the use of cost-sharing agreements for research and development.[99]

---

[96] H.R. Conf. Rep. No. 99-841, note 88, at II-637.

[97] Id.

[98] Id. at II-638.

[99] Id.

=S1 III. Recent History: How the Camel Acquired Its Current Form[100]@

The current state of transfer pricing law and practice reflects a series of compromises reached on an international basis in the first half of the 1990's. Understanding the basis of those compromises helps to explain some of the discontinuities and difficulties encountered in current practice, and also helps to identify the seeds of further reform. We therefore begin our analysis in this Section by describing the reasons why the United States grew dissatisfied with transfer pricing enforcement, and then focus on the solutions that it initially proposed in the White Paper. We then consider the iterative process of comment, negotiation, and compromise that followed, through which the proposed U.S. innovations were shaped into an internationally acceptable form. In the course of changing its own rules, the United States expressed two fundamental sources of dissatisfaction, and as a result pursued two basic sets of changes.

---

[100] Cf. Alec Issigonis, quoted in Oxford Dictionary of Quotations 360 (4th ed. 1992) ("A camel is a horse designed by a committee.").

On a substantive level, the United States expressed frustration with its limited ability to enforce intercompany transfer pricing based on a review of third party comparables. This frustration was expressed both as skepticism that genuine comparables actually existed, and as a related concern that cases were being resolved on the basis of comparables that were excessively inexact. These concerns were particularly acute in the context of intangibles, whose distinguishing feature is, after all, their uniqueness.

On a procedural level, the United States expressed frustration with a transfer pricing system that placed enforcement burdens principally on the government, and did not place explicit self-assessment responsibilities on taxpayers with respect to their transfer pricing practices.

While the changes proposed by the United States in response to the first concern were initially radical in nature, the resulting controversy led to a steady retreat from those initial proposals that ultimately left a relatively modest set of substantive changes in place. On the other hand, the U.S. effort to place responsibility for transfer pricing compliance more squarely on the shoulders of taxpayers worked a basic change in the enforcement landscape, the effects of which have been accommodated only partially by the substantive rules.

=S2 A. The White Paper: Treasury Builds a BALRM, But Nobody Wants to Dance@

In 1988, in response to the congressional directive of 1986, Treasury issued what quickly became known as its "White Paper" on intercompany pricing.[101] The White Paper represents the first comprehensive U.S. government statement in an international debate that arose from congressional enactment of the commensurate-with-income rule in 1986 and ended, at least temporarily, with the release of revised U.S. regulations and OECD Guidelines, respectively, in 1994 and 1995.[102] Despite the intense criticism that it elicited, the White Paper exerted a strong influence on the development of both the regulations and the OECD Guidelines, and an analysis of the White Paper remains of central importance in understanding the shape of transfer pricing regulation today.

=S3 1. Central Economic Argument: Economies of Integration and the Likely Paucity of Comparables@

Early in its analysis, the White Paper frankly acknowledged concerns that had been raised following the 1986 Act by

[101] White Paper, note 68.

[102] See text accompanying notes 86-99 and 186-197. **[x]**

commentators in the United States as well as representatives of foreign governments, to the effect that Congress in 1986 may have initiated a process in which the United States would depart from traditionally accepted notions of the arm's length standard and thereby ignite high levels of double taxation and conflict with the tax authorities of other countries.[103] In response, the White Paper took pains to reassure readers that Treasury did not seek to challenge the then-prevailing notion of the arm's length

---

103

=xt

> Shortly after passage of the 1986 Act, various U.S. taxpayers and representatives of foreign governments expressed concern that the enactment of the commensurate with income standard was inconsistent with the "arm's length" standard as embodied in tax treaties and adopted by many countries for transfer pricing matters. As a result, they argued, the application of the commensurate with income standard would lead to double taxation for which no remedy would exist under treaties, because of application of transfer pricing standards by the United States that would be inconsistent with those applied by various other foreign governments.
>
> To allay fears that Congress intended the commensurate with income standard to be implemented in a manner inconsistent with international transfer pricing norms and U.S. treaty obligations, Treasury officials publicly stated that Congress intended no departure from the arm's length standard, and that the Treasury Department would so interpret the new law. Treasury and the Service continue to adhere to that view, and believe that what is proposed in this study is consistent with that view.

=ft

White Paper, note 68, at 475 (footnotes omitted).

standard—namely, the notion that the different components of multinational groups should be subject to taxation at the same levels they would face if they were unrelated entities.[104]

Nevertheless, the White Paper seems to reflect an understanding of the arm's length standard that departed radically from the conception that, at the time, was the basis of most peoples' understanding of the phrase. Overall, both the economic analysis presented in the White Paper, and the methods that the White Paper offered in reliance on this analysis, constituted a fundamental challenge to the notion that effective transfer pricing administration can be based primarily on reference to uncontrolled comparables.

At the conceptual heart of the White Paper was an extended discussion of economic arguments,[105] to which the 1986 Act's legislative history had alluded[106] and which by 1988 had received prominent exposure in the tax literature,[107] to the effect that

---

[104] See generally id. at 475-76.

[105] Id. at 466-68.

[106] H.R. Rep. No. 99-426, note 87, at 424-25.

[107] See, e.g., Harlow Higinbotham, David Asper, Philip Stoffregen & Raymond Wexler, Effective Application of the Section 482 Transfer Pricing Regulations, 42 Tax L. Rev. 293 (1987); Langbein, note 8, at 654-56.

under a realistic view of the reasons for the emergence of commonly controlled groups of business entities, reasonably close comparables to the transactions entered into among the members of such groups often will not exist. The reason can be found in the fact that integrated groups tend to form precisely because, in particular markets and industries, it has proven more efficient to conduct business in integrated than in nonintegrated form. In such circumstances, a business that seeks to operate in nonintegrated form will face a cost disadvantage and cannot be expected to survive. Thus, the uncontrolled businesses that might serve as the source of comparables within the relevant industry and market segment are not likely to exist.[108]

Numerous examples illustrate this phenomenon. Perhaps the most striking example, and historically most important in the context of transfer pricing, is found in the history of the foreign car market in the United States. When they first entered the U.S. market, some large non-U.S. automobile manufacturers in fact employed unrelated U.S. distributors,[109]

---

[108] See, e.g., White Paper, note 68, at 466-68.

[109] See, e.g., Subaru to Let Fuji Buy Rest of Stock, L.A. Times, May 4, 1990, at D4; cf. Inchcape Sells Toyota (GB), Eur. Intelligence Wire, July 31, 2000, available in LEXIS, Eur.

but quickly this became infeasible (and unnecessary, as the foreign suppliers gained experience in the U.S. market), and those suppliers that had used uncontrolled distributors generally acquired their businesses. Today, the authors are not aware of any uncontrolled distributors of new automobiles in the United States for which financial information is publicly available.

Similar patterns of rapid integration can be seen in a wide variety of industries around the world. As an industry becomes global in scope, there may be an initial period of arm's length dealing between unrelated manufacturers and distributors, but once the market grows and the manufacturers concerned gain experience in the foreign market, the independent distributors rapidly are acquired. Thus, as the White Paper pointed out,[110] those industries in which transfer pricing issues are likely to arise—specifically, those industries that operate in integrated form on a global basis—are industries in which uncontrolled comparables are unlikely to be found.[111]

Intelligence Wire File (describing parent company's purchase of U.K. Toyota distributor).

[110] White Paper, note 68, at 466-68.

[111] Cf. Avi-Yonah, note 8, at 149:

=xt

The economic analyses on which the White Paper is based do not suggest that satisfactory uncontrolled comparables will never be available, and, as seen below, the White Paper would not have eliminated a role for comparables in transfer pricing regulation.[112] For example, particular industries may not have achieved high degrees of centralization of management with attendant economies of integration, so that unintegrated industry participants might co-exist with commonly controlled groups. Some transactions among commonly controlled groups may involve uniform commodities for which market prices are readily available. In some cases, industries may have developed patterns of various kinds of alliances among unrelated entities, which make available close analogues to, for example, license

---

> If comparables can be found, that fact indicates the multinational does not derive a large residual return from its structure because otherwise it could have driven its competitors out of the market. Thus, in these cases it would be possible to use functional analysis without having a comparable. On the other hand, where comparables cannot be found, such as in the majority of complex transfer pricing cases, that fact indicates a large residual is likely, and this residual advantage of the multinational has driven competitors out of the market. Thus, precisely in those situations arising in the majority of transfer pricing cases, where there are no comparables and therefore functional analysis is required, it will be impossible to find the "right" transfer price.

=ft

[112] See text accompanying notes 115-129. **[x]**

agreements between commonly controlled companies. In addition, a particular industry may very recently have made the transition from a nonintegrated to integrated structure so that uncontrolled comparables of recent vintage remain available. Nevertheless, the White Paper plainly adopts an economic analysis that suggests that in many cases, the comparables implicitly assumed by the traditional conception of the arm's length standard will not be available.

Given its attention to economic analysis and its general focus on demonstrating theoretical weaknesses in approaches relying on market comparables, it is somewhat curious that the White Paper did not incorporate the branch of the economics literature showing that rational managers of an integrated business, for reasons unrelated to taxation, often would face an incentive to price intragroup transactions at levels reflecting costs of production, rather than at arm's length levels reflecting some level of profit to the seller.[113] By the late 1980's, highly integrated groups already were common, and the resulting managerial structure of "cost centers," selling goods at cost to "profit centers," was well known.

This element of the literature and the associated widely observed phenomena might have offered an additional reason for

---

[113] See notes 105-108 and accompanying text. **[x]**

understanding the historical difficulties of a system based on the expectation that law-abiding multinational groups naturally would employ prices similar to those that might be observed from uncontrolled comparables. Nevertheless, even the partial economic analysis offered by the White Paper gave ample motivation to suggest what critics soon labeled as radical departures from the arm's length standard as it previously had been conceived.[114]

=S3 2. The White Paper's Transfer Pricing Methods@

It is worth noting at the outset that the White Paper specified that it was recommending transfer pricing methods only for use in connection with transfers of intangibles.[115] Notwithstanding that Congress in 1986 changed statutory rules only with respect to transfers of intangibles, Congress had not directed Treasury to limit its own inquiry in the same manner, but instead instructed Treasury to consider whether transfer pricing regulations should be changed "in any respect."[116]

Moreover, Treasury's theoretical analysis in the White Paper would seem to apply to the pricing of tangible property

---

[114] See text accompanying notes 166-168. **[x]**

[115] White Paper, note 68, at 458.

[116] H.R. Conf. Rep. No. 99-841, note 88, at 638.

and services as well as intangibles. At later stages of the debate, Treasury and other participants widened their focus to address transfer pricing for intangibles and services as well as intangibles, and the regulations and OECD Guidelines ultimately issued did not limit themselves to intangibles.[117]

In its presentation of methods, the White Paper first addressed situations in which regulations should continue to permit compliance to be gauged by reference to uncontrolled comparables.[118] In general, the White Paper recommended a stringent standard under which only "exact comparables" should be permitted to be used as controlling evidence for determining compliance with the arm's length standard. The White Paper did not articulate the boundaries of acceptability of "exact comparables," and indeed indicated that a precise boundary in principle could not be defined. Nevertheless, the discussion makes clear that the standard should be considerably more demanding than previously had been understood.[119] The White

---

[117] For a discussion of the regulations and OECD Guidelines, see text accompanying notes 198-226. **[x]**

[118] White Paper, note 68, at 485.

[119] See, e.g., id. at 486:

=xt

> [T]wo. . . standards should be met. First, the comparable transaction and the related party

Paper then acknowledged a role for "inexact comparables," but indicated that such comparables should not be permitted to serve as the only means of determining compliance with the arm's length standard in any particular instance.[120]

---

arrangement must take place in substantially similar economic environments; these standards may be called "external" ones. Second, the transactions must contain substantially similar contractual features; they must satisfy "internal" standards of comparability.

No amount of general discussion of these standards is likely to turn them into objective tests. As in all matters concerning transfer pricing, facts and circumstances must determine the outcome of specific cases.

=ft

The discussion proceeds to define external factors as those relating to such environmental factors as the level of income to be expected from exploitation of an intangible, and the functions and relative risks performed by the licensor and licensee; internal factors consist generally of contractual terms.

120

=xt

The problem . . . is not that inexact comparables are useless or misleading. Rather, either they have been given too much emphasis in many cases or inappropriate comparables have been used. The proper conclusion is that it is appropriate to make use of them, but that it is inappropriate to determine transfer prices solely on the basis of inexact comparables.

Thus, the White Paper posited a wide range of situations in which methods other than reference to uncontrolled comparables would be required in order to determine compliance with the arm's length standard. To serve this purpose, the White Paper offered a system derived from an analysis of the various fourth methods to which the courts had resorted in resolving cases under the 1968 regulations.[121]

At the heart of the White Paper's proposal was its articulation of what it dubbed the "Basic Arm's Length Return Method" (BALRM). Treasury based BALRM on the view that in many situations, particular components within an integrated group can be characterized reasonably accurately as relatively simple service providers that face limited business risks and that employ only readily measurable capital (typically, tangible capital) in their operations.[122] Within such an operation, it in

---

=ft

Id. at 487.

[121] Id. at 469-71; see also text accompanying notes 68-80.

[122] Probably in an effort to avoid suggesting reliance on the contract manufacturer paradigm that the 1986 legislative history had rejected, the White Paper generally avoids direct articulation of the limited-risk model on which BALRM depends. See generally White Paper, note 68, at 488-89. Nevertheless,

the model certainly is present. See, e.g., id. at 489 (footnotes omitted):

=xt

> Assume, as stated, that the only function to be performed by Widgetco's foreign affiliate is manufacturing and that this function does not involve the significant use of intangible property developed by the affiliate or purchased by it from unrelated parties. Under the rate of return method, the assets of the foreign affiliate would be divided into liquid working capital and all other assets (i.e., the production assets). The actual return on the liquid working capital will be identified and allocated to the foreign affiliate. Rates of return on production assets used in similar manufacturing activities of similar risk must be identified or estimated. Income will then be allocated to the affiliate for its manufacturing activity in an amount equal to the identified or estimated rate of return as applied to its production assets. This rate of return would include, by definition, a return on routine manufacturing intangibles that manufacturers commonly possess as well as a return for assuming normal business risks that manufacturers bear with respect to their investment in manufacturing facilities and inventories. The residual amount of income from the line of business is allocated to Widgetco.

=ft

Interestingly, as Langbein points out, the limited risk model had been articulated as early as the Carroll report:

=xt

> If we recognise the fact that the real centre of management, especially if it is situated at the principal productive establishment, is the most vital part of the enterprise, the most practical approach to the problem is to give it the residuum of profit after allocating to each outlying secondary establishment compensation for the services it has rendered to the

theory should be possible to identify and measure the capital employed by that entity and then to benchmark the "arm's length" rate of return to be expected of that entity by reference to market rates of return observed on similar categories of capital assets.[123]

Even if the actual capital used by such a routine entity could not be measured directly (for example, as in a commission-based distribution operation, the capital of which probably would consist predominantly of work force in place and customer relationships), it might be possible to benchmark the return on capital indirectly, perhaps by reference to returns on cost earned by entities that are similarly configured.[124] The White

---

> enterprise in accordance with what would be paid to an independent enterprise rendering such services.

=ft

Langbein, note 8, at 633, quoting Carroll Report, note 16, at 192.

[123] White Paper, note 68, at 489.

[124]

=xt

> A common alternative [to the use of the return on capital employed as a benchmark] is the ratio of income to operating costs. For example, in the DuPont case, an expert witness, Dr. Charles Berry, computed the ratio of gross income before reduction by operating costs and interest to operating costs for DISA, DuPont's Swiss affiliate, and for a number of unrelated parties performing similar functions. This

Paper argued that the approach of evaluating compliance with the arm’s length standard by reference to returns on capital, or from alternative measures of profitability when necessary, conformed to the arm’s length standard as properly conceived.

=xt

> The use of both types of unrelated party information is consistent with the fundamental goal of the basic arm’s length return method, which is to use information about unrelated parties to determine the returns that would have been earned had the related parties’ activities been undertaken at arm’s length. Therefore, both approaches are potentially applicable depending upon the availability of either type of information and the appropriateness of using either type of information in the particular circumstances.[125]

=ft

> analysis is useful to measure returns on service activities and in other situations where assets are difficult to measure consistently or, more generally, where there is reason to believe that the relationship between income and costs is more stable or easier to measure than the relationship between income and assets. As is true with assets, it is important to consider the types of costs and their relationships to income earned, not just the totals. For example, some analysts have used the ratio of gross income to “above the line” costs. This approach is suspect if the unrelated parties incur proportionately larger amounts of “below the line” costs, such as advertising, than the related affiliate incurs.

=ft

Id.

[125] Id.

The White Paper provided little detail regarding the manner in which the market data necessary to apply BALRM might be assembled and evaluated, or how the functional analysis needed to identify those entities conforming to the BALRM paradigm might be performed. Nevertheless, the White Paper provided several examples that demonstrate the flavor of what apparently was intended.[126] These examples conform fairly closely to the manner in which the U.S. transfer pricing method that is derived from BALRM, the comparable profits method (CPM), is applied in practice today. In particular, the examples envision searches of databases containing financial information provided by publicly traded companies, and the statistical analysis of the resulting data to identify a range of appropriate levels of profitability to be used for benchmarking.[127]

Regardless of one's views concerning the merits of BALRM and its progeny, it is clear that BALRM represented an important conceptual shift from prior governmental formulations of the arm's length standard. BALRM represented the first governmental effort to incorporate into transfer pricing rules the specific recognition of the behavior of integrated groups, and in particular to come to grips with the likelihood that

---

[126] Id. at 528-31.

[127] See text accompanying notes 256-273. **[x]**

transactional comparables often will not be available. At the same time, the White Paper at least claimed for itself the goal of remaining faithful to what might be seen as the conceptual core of the arm's length standard: namely, the notion that the effective tax burden on the income of integrated businesses should not deviate systematically from the burden imposed on the income of businesses not operating in an integrated form.[128]

Moreover, the factual paradigm on which the BALRM model is based, under which some parties to controlled transactions perform relatively simple functions while one or more others perform a central "entrepreneurial" role, seems to conform in fact to the overall structure of at least some multinational businesses. Further, from an administrative standpoint, since BALRM is a one-sided transfer pricing method, revenue authorities in one country can apply it by reference to financial data only of the entity located in the authority's own jurisdiction without the need for data of other members of the commonly controlled group.

Nevertheless, the White Paper's discussion of BALRM did not satisfactorily address a number of significant problems presented by this innovation—a failure that quickly resulted in

[128] White Paper, note 68, at 483.

an explosion of criticism.[129] Before turning to consider the debate that followed the publication of the White Paper, however, it is worthwhile noting some alternative approaches to which the White Paper did not give significant weight, and which potentially could have offered alternative solutions at least as promising as BALRM.

=S3 3. An Ex Post Critique of an Ex Post Approach: The White Paper, Profit Split Methods, and Cost Sharing@

Profit split approaches already had a long heritage under the case law as fourth methods at the time the White Paper was written, and the White Paper accorded profit splits an acknowledged role in the transfer pricing system. The White Paper's treatment of profit splits, however, is brief,[130] and in conceptual format it is surprising. The White Paper treats the profit split approach as mainly an extension of the limited-risk BALRM approach. Indeed, the White Paper's discussion of profit splits is entitled "Profit Split Addition to the Basic Arm's Length Return Method,"[131] and the discussion begins by suggesting that profit splits should apply only in unusual cases, when the

---

[129] See text accompanying notes 166-182. **[x]**

[130] White Paper, note 68, at 490-91.

[131] Id. at 490.

more generally applicable BALRM approach does not prove sufficient.[132]

By treating the profit split approach as a special case of the limited-risk model, the White Paper would appear to have reversed the sequence of analysis that the White Paper's overall conception of commonly controlled groups would appear most naturally to suggest. If one accepts the model of an integrated enterprise as a joint economic venture over which the different participants essentially are free to shape their mutual arrangements in any manner that seems most efficient,[133] then it is the profit split that suggests itself as the generally applicable model, with the one-sided paradigm of BALRM, in which all risks and entrepreneurial activity are contained in a central entity, as a special case.

The White Paper, moreover, not only provided a limited role for profit splits in its overall conceptualization of the transfer pricing issue, but also recommended that the Service permit the use of only a single kind of profit split method[134]—

---

[132] Id. ("Although the basic arm's length return method should be widely applicable, there are situations in which its use alone will clearly be inadequate.").

[133] Cf. text accompanying notes 230-244. **[x]**

[134] White Paper, note 68, at 490-91.

specifically, a roughly described precursor to what became known in the U.S. regulations as the "residual profit split" method.[135] In keeping with the White Paper's approach, the residual profit split method remains, as a practical matter, the only kind of profit split specified for use by the U.S. regulations today.[136]

Under the residual profit split method as described in the White Paper,[137] the tax authority first is to identify, within the activities of both of the parties to a particular set of controlled transactions, a subset of "routine" activities such as basic manufacturing or distribution functions. These activities are to be assigned appropriate levels of income by applying BALRM. Any income not accounted for by this "routine" income is to be divided between the parties in accordance with the relative values of the parties' "significant intangible assets."

Unlike later versions of the residual profit split method,[138] which permit estimation of the parties' relative contributions of intangibles based on measurement of their relative contributions to the development of the intangibles,

---

[135] Reg. § 1.482-6(c).

[136] See text accompanying notes 207-210. **[x]**

[137] White Paper, note 68, at 490.

[138] See text accompanying notes 207-210. **[x]**

the White Paper offered no particular method for dividing the residual income remaining after assigning the parties their appropriate routine returns. Instead, the White Paper frankly described the problem as "difficult," and noted that tax authorities typically would not be able to locate information from comparables from which to estimate the relative values of the parties' intangibles.[139]

The White Paper suggested two sources of information that might be useful: (1) evidence of actual transactions between unrelated parties that are similar to the transactions between the related parties under examination, and (2) evidence from recent purchases and sales from which the values of particular intangible assets might be inferred.[140] The White Paper,

---

139

=xt

> In splitting [the] residual amount between the related parties, it is not necessary to place a specific value on each party's intangible assets, only a relative value. Of course, it is easier to state this principle than to describe in detail how it is to be applied in practice. In many cases, there will be little or no unrelated party information that will be useful in determining how the split would be determined in an arm's length setting. Furthermore, the costs of developing intangibles, even if known, may bear no relationship to value, especially in the case of legally protected intangibles, and generally should not be used to assign relative values to the parties' intangible assets. Splitting the intangible income in such cases will largely be a matter of judgment.

however, did not display a great deal of optimism that such information in fact will be available, or if available, will prove very useful.[141] One is left with the feeling that the White Paper treated its discussion of profit splits as a relatively unimportant addendum to the core of its analysis, the exposition of the BALRM approach.

Similarly, the White Paper does not demonstrate much interest in exploring the broader implications of cost sharing. Following the congressional mandate of 1986,[142] the White Paper does accord cost sharing a place in a future transfer pricing system, and in fact devotes two chapters to the history of cost sharing and technical issues to be addressed in its implementation.[143] Missing from the White Paper, however, are: (1) a discussion of the dramatic contrast between the cost sharing model and traditional conceptions of retrospective enforcement of transfer pricing rules by reference to

---

=ft

White Paper, note 68, at 490.

[140] Id. at 490-91.

[141] Id. (for example the White Paper sought comments on how its analysis might be implemented).

[142] See text accompanying note 98.

[143] White Paper, note 68, at 493–500.

comparables, (2) consideration of why cost sharing by 1988 had persisted in the body of U.S. transfer pricing law for more than 20 years, despite its lack of conformity with the approach followed elsewhere in the law, and (3) most importantly, any consideration of whether the cost sharing model might suggest ways in which the arm's length standard might be applied more satisfactorily.

The White Paper's omission of such discussion is particularly unfortunate in light of the fact that cost sharing, unlike other approaches with arguably formulaic characteristics, generally had been a creature of the taxpayer community and was (and remains) popular. Moreover, although the tempers of many participants in the transfer pricing debate already had been substantially inflamed, the White Paper was written at a time when the debate had not yet rigidified into a pattern under which any approach not depending heavily on uncontrolled comparables was automatically viewed as an attempt at heightened U.S. enforcement and therefore seen by many with suspicion.[144] Thus, with the advantage of 20-20 hindsight, reforms based on a cost sharing approach, particularly if offered in 1988, might

[144] See text accompanying notes 169-182. **[x]**

have been more politically palatable than the approaches the White Paper in fact explored.[145]

=S3 4. Procedural Concerns of the White Paper: Toward a Fundamental Change in the Landscape@

Although the White Paper proposed to address Treasury's substantive concerns about the availability and use of comparables, the White Paper also addressed the procedural framework in which transfer pricing compliance and enforcement took place.[146] In particular, Treasury expressed concern about the extent to which the burden of verifying compliance with the arm's length standard traditionally had rested upon the tax administration, and in effect suggested that more of that burden should shift to taxpayers.

The White Paper addressed these procedural concerns in some detail, based in part on a survey of IRS audit personnel,[147] and summarized its findings as follows:

=xt

> Service experience has been that many taxpayers do not rely upon any form of comparable transactions or other contemporaneous information either in planning or in defending intercompany transactions. Although the

[145] See id.

[146] White Paper, note 68, at 461.

[147] Id. at 461, 500-20.

legislative history to the 1986 Act expresses concern that industry average royalty rates are used by taxpayers to justify royalties for high profit intangibles, the more serious problem has been that the taxpayer, not having structured the transaction with any comparable in mind, seeks to defend its position by finding whatever transaction or method gets closest to the transfer price initially chosen, whether that be an industry average rate of return or some other type of comparable.[148]

=ft

The White Paper concluded that changes in the regulatory regime were required:

=xt

The section 482 regulations are deficient in not requiring taxpayers to document intercompany pricing policies and to supply information upon examination. The section 482 regulations should be amended to require taxpayers to document the methodology used to establish transfer prices prior to filing the tax return and to provide such documentation during examination within a reasonable time after request.[149]

=ft

The White Paper also recommended consideration of a broader use of penalties:

=xt

The assertion of appropriate penalties is a necessary but often ignored element of transfer pricing compliance. In conjunction with the Service's broad-based review of penalties, the Government should determine whether existing penalties are sufficient to: (a) compel taxpayers to provide thorough and

---

[148] Id. at 462 (footnotes omitted).

[149] Id. at 464.

> accurate information . . .; and (b) deter taxpayers from setting overly aggressive and unjustified transfer prices . . . [150]

=ft

The now-familiar documentation and penalty rules established under § 6662 subsequently combined these two themes of contemporaneous documentation and enhanced penalties,[151] and changed transfer pricing practice in ways that are only now becoming fully apparent.

=S2 B. The Debate Over Net Income Benchmarking@

=S3 1. The 1992 Election and the Arm's Length Standard@

The White Paper's central substantive innovation was its BALRM proposal for enforcement based on net income benchmarking. The drafters of the White Paper did not expect their proposals to constitute the last word on their suggested approach, and they probably expected a prolonged period of focused review and criticism by interested parties. Unfortunately, however, the period of time during which the White Paper was drafted and the years immediately following involved a series of developments that inflamed the debate over transfer pricing policy, greatly

[150] Id. at 465.

[151] See text accompanying notes 222-226. **[x]**

reducing the chances of dispassionate evaluation, constructive criticism, and a fully rational outcome.

First, in the *Bausch & Lomb*[152] and *Sundstrand*[153] cases, the Tax Court twice repeated its earlier rejection in *Eli Lilly*[154] of the "contract manufacturer" argument put forth by the Service to the effect that the licensee in an intragroup license of U.S.-developed intangibles ordinarily could be expected to earn only a limited-risk level of return, with the remainder repatriated to the United States as a royalty or in some other form. Some viewed BALRM as a restatement of the contract manufacturer approach that the courts had repeatedly rejected as overly harsh, as had the Ways & Means Committee in its 1985 report.[155]

Second, in the late 1980's, California and the governments of other countries, particularly the United Kingdom, were engaged in heated battles over whether California could take into account income generated outside the borders of the United

---

[152] Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525 (1989), aff'd, 933 F.2d 1084 (2d Cir. 1991).

[153] Sundstrand Corp. v. Commissioner, 96 T.C. 226 (1991).

[154] Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part, rev'd in part and remanded, 856 F.2d 855 (7th Cir. 1988).

[155] H.R. Rep. No. 99-426, note 87, at 426 (rejecting contract manufacturer approach).

States in determining the "unitary" income of a business group that then would be apportioned among California and other states using the generally applicable three-factor formula.[156] This battle, as a logical matter, did not involve the question of the relative merits of the formulary versus arm's length models of income apportionment. Instead, it involved the essentially constitutional question of how much of the tax base from multinational business a state government under the U.S. federal system could properly reach. Nevertheless, the battle over California's approach to unitary taxation contributed in an impressionistic way to an identification of formulary approaches with aggressive and arguably unfair governmental enforcement efforts.[157] As the debate progressed, the word "formulary" became something of a shibboleth. The allegation that a method (such as Treasury's BALRM approach) invoked a formulary model was considered in itself by some to be a sufficient criticism of the merits of the method.

Third, the scope of political concern over transfer pricing enforcement in the United States was expanding beyond its traditional focus on outbound migrations of business activities from the United States to situations involving income earned

[156] Cf. Langbein, note 8, at 669-72.

[157] Id.

from the distribution of tangible products. In particular, some observers during the late 1980's and early 1990's perceived a tendency of the U.S. distribution subsidiaries of foreign (often Japanese) manufacturers to earn persistently low levels of income, or losses, from their U.S. operations.[158] There appears to have been a high level of Service enforcement activity

---

[158] See note 160. Such concerns even found their way into the popular media. For example, a 1992 ABC report, entitled "No Yen for Taxes," had the following lead-in by Sam Donaldson:

=xt

> Good evening. As you frantically try to get your federal income tax return in shape and pay up anything you may owe Uncle Sam by next week's deadline, it might interest you to know who the biggest tax evaders are in America, the people who pay less in taxes on what they take in than anyone else. According to Congressional investigators who've been studying that question, it's the U.S. subsidiaries of foreign corporations, particularly Japanese corporations. At a House hearing today, evidence was laid out suggesting these foreign corporations are getting away with murder when it comes to not paying their fair share of taxes. Tonight we'll show you how they do it and why the IRS has so far been either unable or unwilling to do much about it.

=ft

Primetime Live (ABC television broadcast, Apr. 9, 1992), available at LEXIS, News Library, Transcripts File.

against such subsidiaries.[159] Then-pending debates over the contract manufacturer model and its BALRM cousin seem related to

---

[159] Cases involving U.S. affiliates of Japanese companies generally did not lead to published judicial opinions, because the availability of an income tax treaty between the United States and Japan would have resulted in such cases generally being resolved through the competent authority process. Nevertheless, press reports suggest a high level of enforcement activity against U.S. affiliates of Japanese companies. See, e.g., Kawasaki Transfer Pricing Dispute With IRS, NTAA Settled, Sources Say, Daily Tax Rep. (BNA), Dec. 11, 1992, at D-6; IRS, NTAA Agree Matsushita's 1989 Income Realized in Japan, Daily Tax Rep. (BNA), Dec. 22, 1992, at D-11; Nissan to Pay $160 Million to IRS to Settle 1985-1988 Transfer Pricing Dispute, Daily Tax Rep. (BNA), Nov. 16, 1993, at D-13; NEC Corp. Reveals it Was Subject of IRS Deficiency, Daily Tax Rep., Oct. 14, 1994, at D-6; IRS, Japan's NTA Reach Settlement in Hitachi Transfer Pricing Dispute, Daily Tax Rep. (BNA), Oct. 26, 1994, at D-3; Some 20 Cases in U.S.-Japan Negotiations But Several at Stalemate, Sources Say, Daily Tax Rep. (BNA), Feb. 21, 1995, at D-5. Andrew Pollack, Big Japan Concern Reaches an Accord, N.Y. Times, Nov. 11, 1992, at A1, reports an advance pricing agreement

this enforcement concern, since distribution subsidiaries appear on their face to conform to the limited-risk model that Service enforcement personnel and Treasury officials apparently had in mind in positing the notion of entities that, at arm's length, would earn limited but steady rates of return.

Political concern with the allegedly low levels of income of U.S. subsidiaries of foreign companies became so substantial that legislators offered serious proposals for the imputation of minimum levels of taxable income for foreign-owned subsidiaries, in apparent contravention of international tax norms.[160] The

---

involving the Matsushita Electric Industrial Company and observes:

=xt

> Numerous Japanese companies are in disputes with the I.R.S. over transfer pricing. In a survey of 328 Japanese companies conducted in December by Keidanren, a lobbying organization for Japanese business, 47 companies said they had had disputes within the last five years with the I.R.S. and an additional 107 companies said they were afraid they would have problems in the future.

=ft

[160] Cf., e.g., Rostenkowski, Gradison Introduce Foreign Tax Reform Legislation, Daily Tax Rep. (BNA), May 28, 1992, at D-16; Statement of Rep. Duncan Hunter, Testimony Before the Oversight Subcommittee of the House Ways and Means Committee, 92 TNT 77-68, Apr. 10, 1992, available in LEXIS, TNT File (testimony

transfer pricing issue even enjoyed a brief period of notoriety in the general press as an issue in the 1992 U.S. presidential campaign.[161]

To the extent that U.S. subsidiaries of foreign companies in fact were earning relatively low levels of income in the United States during the late 1980's and early 1990's, factors unrelated to taxation may have contributed to the phenomenon. For example, it has been suggested that the appreciation of the yen relative to the dollar after 1985 made it difficult to manufacture property in Japan, paying for inputs in yen, and to

---

emphasizes issues relating to U.S. subsidiaries of Japanese manufacturers); Summary of Statement of the National Foreign Trade Council, Inc. (NFTC) to the House Ways Committee on H.R. 5270, "The Foreign Income Tax Rationalization and Simplification Act of 1992," 92 TNT 149-140, July 22, 1992, available in LEXIS, TNT File (statement argues minimum tax proposal violates international standards).

[161] See, e.g., Daniel Southerland, Bush, Clinton Bring Obscure Tax Issue to Forefront in Their Stump Sparring--Candidates Disagree Over Cracking Down on Foreign-Owned Firms, Wash. Post, Oct. 3, 1992, at A12.

sell the output profitably in dollars in the United States.[162] Under a "joint venture" model of arm's length relations among members of integrated groups, such difficulties presumably would have been shared between the Japanese parents and the U.S. subsidiaries under some form of profit split method. Under a BALRM approach, the subsidiaries would have been expected to continue earning positive levels of income in the United States,

---

[162] The transfer pricing implications of the declining dollar were felt not only in Japan. Thus, comments sent to Treasury in 1992 by the Association of German Chambers of Industry and Commerce and the Federation of German Industries included the following:

=xt

> Since the U.S. dollar exchange rate has fallen against almost all foreign currencies since 1985, this is one of the most important economic factors which can have a negative influence on the income of the "foreign" company. This ongoing development of the U.S. dollar against other currencies is surely one of the main causes for the declining profitability of U.S. subsidiaries of foreign companies as compared to home-grown U.S. companies.

=ft

Proposed Regs Alarm German Industry, 92 TNI 34-63, Aug. 19, 1992, available in LEXIS, TNI File.

at least for a time, on the theory that the subsidiaries were providing limited-risk services to the Japanese parents.[163]

Ultimately, the audit disputes arising during the late 1980's and early 1990's seem to have been resolved through competent authority negotiations in which the Japanese government pressed for application of a profit split model, the United States pressed for use of a one-sided approach, and the two sides apparently compromised by the formulation of various kinds of "hybrids."[164] The process of resolving these disputes, however, took several years, and no resolution was in sight in the early the 1990's. Thus, during the period in which transfer pricing rules were debated internationally, officials not only in Japan but also other countries may have perceived the U.S. proposals for simplified one-sided methods of transfer pricing,

---

[163] Cf. generally Joseph H. Guttentag & Toshio Miyatake, Transfer Pricing: U.S. and Japanese Views, 8 Tax Notes Int'l 375 (Feb. 7, 1994); Tax Experts Say Japan Moving Toward Profit Splits as Key Pricing Method, Daily Tax Rep. (BNA), June 2, 1994, at D-3.

[164] See U.S. Japan Authorities Agree to First "Hybrid" Method APA, Sources Say, Tax Mgmt. Transfer Pricing Rep. (May 22, 1996); NTA, IRS Continue to Use Hybrid Method in Bilateral APA Negotiations, Sources Say, 6 Tax Mgmt. Transfer Pricing Rep. 186 (July 16, 1997).

such as BALRM, as constituting barely disguised minimum tax proposals designed to force resolution of pending disputes on terms favorable to the United States.

Non-U.S. governments generally do not seem to have shared the high level of political and administrative concern in the United States concerning transfer pricing issues. Countries other than the United States instead often seemed generally content with the historical levels of enforcement (or, as often seems to have been the case, non-enforcement) generally found around the world.[165] Understatements of taxable income by some companies, it was expected, generally would be balanced by overstatements of others; the system by and large could manage itself, at least in the context of transactions between two countries that each would impose a significant rate of tax,

---

[165] See, e.g., Guttentag & Miyatake, note 163, at 387 (observing that 1993 version of U.S. regulations "ignored previously enunciated requests to limit transfer pricing adjustments to abusive situations"); cf. Kathleen Matthews, U.S. Treaty Partners Express Reservations Over White Paper, 88 TNT 220-1, Oct. 31, 1988, available in LEXIS, TNT File (reporting view of Canadian official that principles of White Paper should apply only in situations involving tax havens).

leaving companies with little incentive to shift income between them.

From the standpoint of many foreign governments, therefore, the U.S. initiatives appeared to be a parochial overreaction to concerns that the foreign governments did not share. The foreign governments, however, could not ignore the U.S. initiatives. Enhanced U.S. enforcement threatened to force other countries to take similar measures to protect their own tax bases; the result could well be increased enforcement costs on the part of all, with little significant change to the original global distribution of taxable income.

=S3 2. Criticism of Net Income Benchmarking@

The debate over net income benchmarking began in the form of comments on the White Paper itself, but the dialogue continued as the United States issued proposed regulations in 1992 that would have implemented a version of the White Paper's proposal[166] and again issued revised proposed and temporary regulations in 1993.[167] In each instance the United States

---

[166] Prop. Reg. § 1.482, 57 Fed. Reg. 3571-01 (Jan. 30, 1992).

[167] Prop. and Temp. Reg. § 1.482-1T to -7T, 58 Fed. Reg. 5263 (Jan. 21, 1993).

requested comments on its proposals, and in each instance it received them in great number. The comments were often antagonistic; combined, they could fill many printed volumes.

Both business representatives and foreign governments themselves provided highly negative comments.[168] The reactions

---

[168] Avi-Yonah, note 8, at 140-41, summarizes briefly the official comments. Apparently, the volume of comments was so high as to constitute a constraint on Treasury's workflow. See Treasury Is "Enmeshed" in Review of Comments on Transfer Pricing Regs., 92 TNT 214-44, Oct. 23, 1992, available in LEXIS, TNT File. Reflecting the flavor of the comments received over the years are, for example, the following: Matthews, note 165, at 595 (reporting comment of Japanese tax official, Go Kawada, that under the White Paper approach, "'taxpayers would tend to report an unnecessarily large amount of income to the IRS . . . .'"); Proposed Regs. Alarm German Industry, 92 TNI 34-63, Aug. 19, 1992, available in LEXIS, TNI File (reporting comment that "[t]he basic departure from prevailing international consensus is that the new regulations are based on the combined effects of all transactions. By this means it is possible to make global income adjustments."); International Chamber of Commerce Says BALRM Method Is Just Another Form of Unitary Tax, 89 TNT 76-42, Apr. 6, 1989, available in LEXIS, TNT File (quoting Wolfgang

of both groups were not surprising. As was true of the House formulary proposal in 1962, the U.S. proposals plainly had originated from concerns that Treasury was collecting less than its fair share of tax revenues. The U.S. proposals were intended to increase the U.S. tax burdens of multinational companies. The financial burden of the intended U.S. tax increase would be shared, under existing global institutions designed to prevent double taxation, in some measure between the businesses themselves and the governments of other countries.

While there are significant differences among the various versions of the net income-based proposals advanced by the United States, and also many differences among the criticisms that commentators raised, there are also sufficient similarities that it is possible to identify four basic criticisms raised by commentators in various forms to the U.S. proposals. Experience since the end of the recent debates permits additional

---

Ritter, Chairman of the Comm'n on Tax'n of the Int'l Chamber of Commerce) (alteration in the original): "'BALRM analysis does exactly what unitary taxation does: instead of looking at the actual prices charged between related entities, it looks at the total profits earned by a number of entities and divides them up by reference to criteria determined by academic economist[s] with no experience of the real business world.'"

finetuning of criticisms that might be raised generally concerning the BALRM approach (and its CPM and TNMM successors). In the following summary, we seek to articulate and evaluate criticisms of Treasury's benchmarking approach that remain relevant to policymaking today.

=S4 a. General Criticism of Reduced Reliance on Comparables@

The first type of criticism accused Treasury of upsetting commonly applied international norms by replacing the system's reliance on comparables with economic analysis as the normal basis for enforcing compliance with the arm's length standard.[169] This was indeed what Treasury had sought to do in the White Paper, which was based on the view that (1) uncontrolled comparables often would not be available, (2) attempts to rely on the availability of uncontrolled comparables had hampered enforcement efforts, and (3) enforcement techniques based on economically derived estimates of "arm's length rates of return" could serve as the basis for a more effective enforcement system.[170]

The White Paper did not explicitly seek to abandon reliance on comparables, but the White Paper's understanding of the term

---

[169] See Section III.A.1.

[170] White Paper, note 68, at 458-63.

certainly departed from traditional conceptions. Traditionally, for example, a comparable for controlled sales of automobiles might consist of uncontrolled sales of automobiles, or perhaps of closely allied products such as light trucks. The BALRM approach, however, viewed the notion of comparability quite differently. Since what was being measured ultimately was a market return on capital, and capital is fungible, information could be gathered from virtually any industry (provided that the industry did not typically make use of unique intangibles that would not find their way in a reliably measurable way onto corporate balance sheets).[171] Thus, the image created by the White Paper was that of an economist evaluating statistical data from broadly defined categories, not a case-specific analysis of the similarity of different transactions.

Many critics of the BALRM approach probably expected that as a practical matter the traditional kinds of comparables were much less likely to be identifiable than the kind of industry data envisioned by Treasury. Thus, embedded not very deeply in the theoretical debate was the fundamental practical question of how easy the rules should be to enforce on a day-to-day basis. Despite all the debate of the late 1980's and early 1990's, neither Treasury nor the OECD has yet resolved that question

---

[171] Id. at 488-90.

clearly; it remains very much open today. Indeed, the system today is internally inconsistent with respect to this question, since on the one hand it seeks increasingly to force taxpayers to carry out transfer pricing analysis on an ex ante basis, while on the other hand it avoids providing taxpayers with practical means of doing so in a manner that can be protected against future second guessing by one or more tax administrations.

=S4 b. Criticism of Claims Regarding Net Profits Analysis@

As noted above, the U.S. approach to net profits benchmarking relies on the view that the net returns, as opposed to the gross returns, of different companies could be expected over time to converge.[172] Similarly, the United States has maintained that an advantage of net profits benchmarking over the traditional cost plus and resale price methods is that a lack of functional or product comparability has a smaller effect

---

[172] For example, the preamble to the final regulations states that the CPM method "relies on the general principle that similarly situated taxpayers will tend to earn similar returns over a reasonable period of time." Preamble to Reg. § 1.482-5, T.D. 8552, 1994-2 C.B. 93, 109.

on the reliability of the analysis.[173] As discussed further immediately below, it is not evident from economic theory why these assertions should be true, and none of the materials published by the United States explain the point.

To the contrary, the distinction between transfer pricing methods based on net and gross income was largely irrelevant in the early 1990's, as it remains today. From their inception, the gross income methods such as cost-plus and resale price were to be applied with reference to any differences in entities' functions that might be expected to affect profitability.[174] Thus, the gross income methods could be applied only by taking into account functions that can be measured only by reference to below-the-line costs (that is, costs that affect the computation of net income from the starting point of gross income). There

---

[173] Specifically, the regulations provide as follows:

=xt

> The degree of functional comparability required to obtain a reliable result under the comparable profits method, however, is generally less than that required under the resale price or cost plus methods. For example, because differences in functions performed often are reflected in operating expenses, taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit.

=ft
Reg. § 1.482-5(c)(2)(ii).

[174] Reg. § 1.482-1(d)(3)(i).

is no material difference between benchmarking against gross income while making adjustments for functions related to below-the-line costs, and benchmarking directly based on net income. It is thus far from clear why a different standard of comparability could be justified in connection with the use of net rather than gross income benchmarks.

What does matter, however, regardless of whether a method is based on net income or is based on gross income but with reference to below-the-line expenses, is the extent to which enforcement authorities are required as a practical matter to identify functionally similar comparables in order to assert adjustments to taxpayers' reported income. As discussed below, this core question remains unresolved today.[175]

=S4 c. Criticism of Underlying Economic Theory@

The White Paper based BALRM on the "zero-profit" concept in microeconomics, which is the notion that competition, by attracting new entrants to activities with higher-than-normal rates of return on capital, and causing the flight of capital from activities that provide lower-than-normal returns, will

---

[175] See Section II.A (discussing the similarity of the comparable profits method and the transactional net margin method as well as the appropriate applicability of each method).

cause returns on capital to equilibrate at a normal level.[176] That idea is correct as a general matter, but the equilibration that it describes is in fact a highly dynamic process, involving constant entry and exit from an infinite and constantly changing variety of economic activities. The economy never reaches the equilibrium posited by the zero-profit model; it is a theoretical construct that does not describe the reality at any given instance among small groups of competitors.[177] Rather, the essence of competition is experimentation, with a consequent

---

[176] White Paper, note 68, at 484 (describing the zero-profit analysis).

[177] It should be emphasized that the current discussion in no way is intended to suggest that the zero-profit concept is not valid as a matter of economic theory, or that the concept is not useful as a guide to policymaking or business analysis. To the contrary, the notion of an economy-wide, market level of return on limited-risk capital is fundamental in both economic theory and practice. What is argued here, however, and is explained below by reference to the conceptual underpinnings of the capital asset pricing model, is that the use of the zero-profit model to benchmark the behavior of a single firm, or a small group of firms, is conceptually invalid. See notes 178-182 and accompanying text. **[x]**

mixture of success and failure. In reality, at any given moment, and even over relatively extended periods of time, even closely similar competitors will exhibit a wide range of market returns.[178]

Indeed, one of the central concepts in contemporary economic theory, the capital asset pricing model (CAPM), to which the White Paper does not refer directly but which almost certainly contributed to its image of a routine rate of return,[179] is designed primarily to explain why capital markets can operate in the presence of wide variations of results within particular industries.[180] The CAPM does incorporate the notion

---

[178] See generally John Wills, Risk Measurement: Applying Financial Theory to Transfer Pricing, 52 Tax Notes 1311 (Sept. 9, 1991) (analyzing the effect of market risk on returns and profits and how to properly account for such effects).

[179] An article by one of the White Paper's authors, Daniel J. Frisch, The BALRM Approach to Transfer Pricing, 42 Nat'l Tax J. 261, 265-67 (1989), explains the relevance of CAPM to the BALRM analysis, although the author cautions that his article does not necessarily track the discussions held within Treasury.

[180] For a general description of the CAPM, see Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 197-202 (6th ed. 2000).

of a risk-free rate of return (typically envisioned by financial analysts as the rate of return on high-grade corporate debt), but the CAPM does not even remotely suggest that companies, even within a given industry, are likely over any operationally meaningful period of time to gravitate toward that rate. To the contrary, the main thrust of the CAPM is to show that, through opportunities for investor diversification, markets can function well over an indefinite period of time (that is, investors can assemble portfolios incorporating any desired level of risk), notwithstanding that any particular subsection of the market is likely to consist of companies encountering widely varying levels of success.[181] Far from suggesting that companies

---

[181] Cf. Michael C. Durst, Transfer Pricing Policy Yesterday, Today and Tomorrow, Remarks at Tax Council Policy Institute Seminar 14 n.6 (Feb. 2002) (unpublished manuscript on file with the Tax Law Review), which discuss an example drawn from Wills, note 178, to illustrate this point:

=xt

> Wills posits a gold mining industry in which the cost of prospecting for gold is $100; if successful, the prospecting efforts will yield income of $2,150. It can be predicted with a relatively high degree of confidence that, in the course of a year, 10 percent of prospecting efforts will be successful, and that the rest will constitute total losses. Now, this industry as a whole will have a return on expenses of ($2,150 - $1,000)/$1,000, or 15%; and an investor who invests in a diversified portfolio of all participants

selected from within particular industry groups are likely to exhibit any degree of convergence of results within a meaningful period of time, the CAPM illustrates that the sensible economic assumption is that such convergence will not be found.[182]

---

in the industry will have a very good chance of achieving this return. Assuming, however, for purposes of illustration that there are ten firms in the industry, the [gross incomes of the particular firms] will appear as follows:

1	2	3	4	5	6	7	8	9	10
0	0	0	0	0	0	0	0	0	1,150

The industry as a whole will have a rather humdrum rate of return on expenses of 15 percent, but the interquartile range will run from 0% to 0%. Now, few if any groups of potential comparables will involve skewing of results as dramatic as that shown in this stylized example, but the example illustrates how little reason there is to expect that small samples can be expected to demonstrate any given degree of convergence in result.

=ft

[182] Compare the categorical statement in the White Paper:

=xt

> Microeconomic theory leads to an unambiguous and natural statement of what the income of unrelated parties should be . . . . As long as the industry under analysis is competitive and the factors of production are homogeneous and mobile between sectors, . . . each firm will earn just enough to be able to pay for the land, labor, capital, and other factors of production that it uses to produce its outputs.

=ft

White Paper, note 68, at 484 (footnote omitted); see also Preamble to Prop. and Temp. Reg. § 1.482-5T, 58 Fed. Reg. 5263,

=S4 d. Practical Problems in Applying the BALRM Approach@

Beginning with the White Paper's discussion of BALRM, and continuing through the various regulatory iterations of the CPM, the U.S. approach to net profits benchmarking has assumed that taxpayers and tax administrations are able to establish factual predicates that, as a practical matter, are virtually impossible to determine. For example, application of the method requires that the entity on one side of the controlled transactions did not bear the financial risk of developing valuable intangibles. This requires a finding, for example, that the party's expenditures for marketing did not exceed those expected of a routine distributor, or that its expenditures on the perfection of its production processes did not exceed those of a routine manufacturer. Such judgments are exceedingly difficult in practice, and, as discussed in more detail below, the attempts to address them have been unsuccessful to date.[183]

5270 (Jan. 21, 1993) ("The comparable profits method relies on the general principle that similarly situated taxpayers will tend to earn similar returns over a reasonable period of time.").

[183] Notes 283-294 and accompanying text. **[x]**

The White Paper seems to have assumed that the facts required to determine whether a particular situation conforms to the paradigm underlying the BALRM approach will be readily available to taxpayers seeking to comply with the arm's length standard and to tax examiners seeking to evaluate their compliance. This unjustified assumption remained largely unaddressed at later stages of the debates of the late 1980's and early 1990's,[184] and the tax system suffers from this omission today.

Another practical drawback of one-sided transfer pricing methods based on BALRM is the relative instability of such methods during expansionary peaks and recessionary troughs of global economic cycles.[185] The parties to one-sided transfer pricing methods essentially have entered into an agreement, with the host government of the limited-risk entity, to ensure that entity a positive level of taxable income regardless of the

---

[184] See text accompanying notes 166-171. **[x]**

[185] See, e.g., Aydin Hayri & Richard A. Clark, Firm Profitability in Recessions (pts. 1 & 2), 10 Tax Mgmt. Transfer Pricing Rep. 905 (Mar. 6, 2002); 11 Tax Mgmt. Transfer Pricing Rep. 29 (May 1, 2002) (exploring the reliability of comparable profits method analyses during a recession and describing six adjustments created to improve comparability during recessions).

overall income or loss of the multinational group as a whole. If an economic downturn, however, is sufficiently prolonged, the government of the member or members of the group that were not limited-risk (the so-called entrepreneurial member of the group under the transfer pricing model, which typically is the parent company) may not tolerate a period of persistent tax losses while affiliates in other tax jurisdictions continue to report positive taxable incomes. Similarly, in prolonged boom periods, host governments of limited-risk entities may be tempted to challenge application of one-sided transfer pricing methods in the face of very high income levels reported elsewhere in the multinational group.

=S3 3. Sewing the Camel Together: The Regulatory Process and the OECD@

The intensity of the reaction to the White Paper and the proposed regulations, particularly from foreign governments, showed that the United States could not finalize a substantially revised transfer pricing system without extensive consultation with its trading partners. The Committee on Fiscal Affairs of the OECD facilitated intensive discussions at its Paris headquarters among representatives of the finance departments of member governments, with the goal of drafting a replacement for

the OECD 1979 Guidelines[186] that had largely adopted the approach of the 1968 U.S. regulations.

This process of consultation had an evident influence on the development of the U.S. regulations, and a parallel effect on the development of the OECD Guidelines. Indeed, given the

---

[186] Comm. on Fiscal Affairs, OECD, Transfer Pricing and Multinational Enterprises 9-12 (1979) (describing the scope and objectives of the 1979 report). The earlier guidelines had been supplemented by subsequent studies addressing specific transfer pricing topics. Comm. on Fiscal Affairs, OECD, Transfer Pricing and Multinational Enterprises: Three Taxation Issues 5, 43, 71 (1984) (addressing issues related to the mutual agreement procedure, transfer pricing in banking, and the treatment of intragroup services). Guttentag, note 43, at 3 describes the genesis of the process that led to the 1979 OECD report:

=xt

> Following finalization of the regulations, we had them translated into French and got them on the agenda for the next meeting of the Fiscal Affairs Committee. This was a most fascinating experience, explaining the regulations and persuading the delegates of the need for use of the mutual agreement procedures to an extent never used before. As you might imagine there were different reactions. That meeting began the long drawn-out exercise in developing the current procedures, which result in allocations and resulting assessments and refunds of millions of dollars of tax revenue annually.

=ft

nearly contemporaneous publication of U.S. and OECD materials in the 1993 to 1995 period, it fairly might be said that the two processes ran on parallel tracks. At the end of the deliberations, Treasury and the OECD issued, respectively, final versions of the U.S. regulations[187] and the OECD Guidelines.[188] The goal of all parties was to portray the two releases as consistent with one another, and indeed the regulations and the Guidelines are in overall agreement.

The two documents reflect a compromise between the United States and its trading partners.[189] The OECD Guidelines

---

[187] Reg. § 1.482. In the course of the OECD deliberations, the United States issued temporary and proposed regulations in 1993. See note 182. These regulations reflected the course of the then ongoing debates in the OECD and are largely similar to the regulations issued finally in 1994. Preamble to Reg. § 1.482, T.D. 8552, 1994-2 C.B. 93, 98 (stating that "both the form and the substance of the final regulations are generally consistent with the 1993 regulations.").

[188] OECD Guidelines, note 3.

[189] Since the adoption of the OECD Guidelines, many other countries have adopted rules consistent with those Guidelines or are in the process of doing so today. Countries in which the OECD Guidelines either have been adopted formally, or otherwise

acknowledged the acceptability of measures based on net as opposed to gross income.[190] They did so, however, based on the

---

have been incorporated into prevailing rules and practices since their issuance, include Canada, the United Kingdom, New Zealand, South Africa, Germany, and Norway. Additional countries are added to the list almost weekly. See, e.g., Canada's Revised Transfer Pricing Circular, 8 Tax Mgmt. Transfer Pricing Rep. 472 (Sept. 29, 1999); Royal Assent for Finance Bill Completes Largest Transfer Pricing Reform in 50 Years, 7 Tax Mgmt. Transfer Pricing Rep. 325 (Aug. 12, 1998); Examining New Zealand's Revised Transfer Pricing Guidelines, 9 Tax Mgmt. Transfer Pricing Rep. 552 (Nov. 29, 2000); South Africa: Authority Says Taxpayers Should Follow New Guidance Retroactively From July 1995, 8 Tax Mgmt. Transfer Pricing Rep. 377 (Aug. 25, 1999); German Federal Tax Court Issues Landmark Transfer Pricing Decision, 2001 WTD 237-11, Dec. 10, 2001, available in LEXIS, WTD File; Norwegian Supreme Court Approves Use of OECD Transfer Pricing Guidelines, 2001 WTD 205-8, Oct. 23, 2001, available in LEXIS, WTD File.

[190] The Guidelines allow use of a "transactional net margin" method (TNMM) that in form is very similar to the CPM of the U.S. regulations. See generally Robert E. Culbertson, A Rose by Any Other Name: Smelling the Flowers at the OECD's (Last)

U.S.'s retreat from the broader implications of the White Paper's BALRM. That retreat took the form of the increasing deference in the regulations to notions of comparability.

Deference to comparability first appeared when the 1992 proposed regulations abandoned what the preamble described as the White Paper's use of industry averages to establish arm's length rates of return,[191] and was confirmed by the 1993 temporary[192] and 1994 final regulations'[193] more elaborate recitations of the elements of comparability that must be taken

---

Resort, 10 Tax Notes Int'l 370 (Aug. 7, 1995) [hereinafter Last Resort] (discussing the OECD's replacement of the CPM with the TNMM and the differences between the two approaches).

[191] Preamble to Prop. Reg. § 1.482, note 166, 57 Fed. Reg. at 3572 ("The BALRM generally allocated income to the parties to a transaction by assigning industry average rates of return to their assets.").

[192] Prop. and Temp. Reg. § 1.482-1T(c), 58 Fed. Reg. 5263, 5266 (Jan. 21, 1993) (setting forth proposed and temporary regulations).

[193] Reg. § 1.482-1(d).

into account in a CPM analysis.[194] Thus, regardless of what transfer pricing methods are to be used (with the possible exception of profit splits), they must be based on the identification of comparables performing functions similar to those of the controlled party under examination.[195]

The U.S. regulations continue to suggest that the CPM can reliably operate under a looser standard of comparability than the more traditional methods,[196] and as an element of the compromise, the United States wrested from the OECD a limited statement in the Guidelines of at least somewhat similar effect.[197] Presumably the looser standard of comparability that

---

[194] Preamble to Reg. § 1.482-5, T.D. 8552, 1994-2 C.B. 93, 98 (stating that the final regulations would continue to adhere to the 1993 proposed regulations' emphasis on comparability).

[195] The U.S. regulations and OECD Guidelines place slightly different emphases on the degree of functional comparability required, but both documents undeniably require the evaluation of comparables under every available transfer pricing method other than profit split. See notes 202-210 and accompanying text. **[x]**

[196] Reg. § 1.482-5(c)(2)(ii), (iii).

[197] The OECD Guidelines state: "One strength of the transactional net margin method is that net margins . . . are

Treasury envisioned explains why the United States viewed as acceptable a compromise version of CPM that is imbued with comparability notions, even though Treasury's original motivation in proposing BALRM had been to greatly reduce reliance on comparables. The limited willingness of the OECD to accept the idea of a looser standard of comparability, however, apparently prevented Treasury from departing very far from traditional notions in its regulations.

On the other hand, while the final regulations' embrace of comparability may have turned the CPM into a relatively modest expansion of the panoply of transfer pricing methods, another element of the compromise that received far less attention at the time already has changed the landscape fundamentally and probably irrevocably. This of course is the general international acceptance, after only limited initial resistance, of the second major component of the U.S. transfer pricing initiative of the period: the effort to place increasing responsibility for transfer pricing compliance on taxpayers.

---

less affected by transactional differences than is the case with price, as used in the CUP method." OECD Guidelines, note 3, app. ¶ 3.27.

=S2 C. Major Features of the Regulations and OECD Guidelines@

=S3 1. Traditional Measures to Be Used When Feasible@

The U.S. regulations and the Guidelines agree that where uncontrolled transactions can be found that are plainly comparable to transactions between related parties, those comparables should be used as the basis of transfer pricing enforcement.[198] Similarly, where comparables plainly meeting traditional criteria for application of the cost plus or resale price methods can be identified, those comparables should be used.[199]

---

[198] OECD Guidelines, note 3, app. ¶ 2.7 ("Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP Method is preferable over all other methods."). The U.S. regulations generally avoid establishing a formal hierarchy of methods, but they provide that "[d]ata based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length." Reg. § 1.482-1(c)(2).

[199] OECD Guidelines, note 3, app. ¶ 3.49 ("Traditional transaction methods are to be preferred over transactional profit methods . . . ."); id. ¶ 3.50 (describing net income

Both documents state criteria for the acceptability of comparables for use in the traditional transactional methods that are on their face stringent but which inevitably are expressed in ultimately subjective terms.[200] Thus, the extent to

---

based methods as methods of "last resort"). In the U.S. regulations, the preference for traditional, gross income based methods can be inferred from the language of § 1.482-1(c)(2).

[200] The flavor of the subjectivity, under the Guidelines as well as the regulations, governing the question of when comparability will be sufficient to permit use of a traditional as opposed to a profit-based method can be seen from various portions of the documents. Thus, the Guidelines, in addressing the degree of comparability required under the CUP method, provide:

=xt

> In considering whether controlled and uncontrolled transactions are comparable, regard should be had to the effect on price of broader business functions other than just product comparability (i.e. factors relevant to determining comparability under Chapter I). Where differences exist between the controlled and uncontrolled transactions or between the enterprises undertaking those transactions, it may be difficult to determine reasonably accurate adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy. Every effort

should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.

=ft
OECD Guidelines, note 3, ¶ 2.9.

Regarding eligibility for the resale price methods, the Guidelines say:

=xt

Although broader product differences can be allowed in the resale price method, the property transferred in the controlled transaction must still be compared to that being transferred in the uncontrolled transaction. Broader differences are more likely to be reflected in differences in functions performed between the parties to the controlled and uncontrolled transactions. While less product comparability may be required in using the resale price method, it remains the case that closer comparability of products will produce a better result. For example, where there is a high-value or relatively unique intangible involved in the transaction, product similarity may assume greater importance and particular attention should be paid to it to ensure that the comparison is valid.

=ft
Id. ¶ 2.18.

The Guidelines then indicate that the criteria for accepting comparables for use under TNMM are less demanding, although it is difficult, to say the least, to discern from the language precisely by how much:

=xt

Prices are likely to be affected by differences

in products, and gross margins are likely to be affected by differences in functions, but operating profits are less adversely affected by such differences. As with the resale price and cost plus methods that the transactional net margin method resembles, this, however, does not mean that a mere similarity of functions between two enterprises will necessarily lead to reliable comparisons. Assuming similar functions can be isolated from among the wide range of functions that enterprises may exercise, in order to apply the method, the profit margins related to such functions may still not be automatically comparable where, for instance, the enterprises concerned carry on those functions in different economic sectors or markets with different levels of profitability. When the comparable uncontrolled transactions being used are those of an independent enterprise, a high degree of similarity is required in a number of aspects of the associated enterprise and the independent enterprise involved in the transactions in order for the controlled transactions to be comparable; there are various factors other than products and functions that can significantly influence net margins.

=ft
Id. ¶ 3.34.

The U.S. regulations express the difference in the degree of comparability required in order to use the cost plus or resale price methods, as opposed to the CPM, more briefly but in similarly general terms:

=xt

The degree of functional comparability required to obtain a reliable result under the comparable profits method . . . is generally less than that required under the resale price or cost plus methods. For example, because differences in functions performed often are reflected in operating expenses, taxpayers performing different functions may have very different gross profit margins but earn similar levels of

which traditional transactional methods in fact will be acceptable is likely to depend on the attitudes of taxpayers and revenue authorities. If revenue authorities or taxpayers desire a reason for disqualifying comparables in any instance, the regulations and Guidelines leave ample room for such a reason to be found. Thus, in a dispute, it is unlikely that a satisfactory resolution will be reached by reference to the application of comparables in traditional transactional methods. Either side almost always will have the option of disqualifying the claimed comparables by reference to the stringent language in the regulations or Guidelines, forcing recourse to some other method.[201]

---

operating profit.

=ft
Reg. § 1.482-5(c)(2)(ii).

[201] When the 1993 version of the U.S. regulations was released, Avi-Yonah, like many others, predicted that most cases would be governed by the CPM:

=xt

> In effect, whenever the IRS and the taxpayer disagree about the pricing method, which is essentially in every case in which the application of the ALS is important, the two competing methods have to be tested under the CPM. Although the temporary regulations refrained from mandating, they strongly suggested that the method that is consistent with the CPM should prevail. Thus, in the temporary regulations, as in the proposed regulations, unless the taxpayer can find

=S3 2. Profit-Based Methods to Be Used When Transactional Methods Are Unavailable@

Both the regulations and the Guidelines indicate that, when comparables meeting the requirements of the comparable uncontrolled price (or comparable uncontrolled transaction), cost plus or resale price methods cannot be found, methods based on net profitability may be used. Such methods consist of

---

an exact comparable or one that requires only minor adjustments, the CPM will be used to "trump" any taxpayer method (including the CUP) that is inconsistent with its results.

=ft
Avi-Yonah, note 8, at 142 (footnote omitted).

In fact, transfer pricing practice, particularly in the compilation of contemporaneous documentation, relies much more heavily on the CPM than on other methods. Published reports indicate further that the CPM is used in the great majority of APAs issued by the IRS. See Announcement 2002-40, 2002-1 C.B. 747, 759 tbl.16 (Mar. 2002) (summarizing methods used in APAs involving tangible and intangible property; the CPM is cited as being used in 41 of 75 total instances and the CPM appears much more frequently than any other method); id. at 760 ("The CPM is frequently applied in APAs.").

either a method that the U.S. regulations label as the CPM[202] and the OECD Guidelines label as the TNMM,[203] or of profit split methods.

=S4 a. CPM/TNMM@

Both the CPM and the TNMM are structurally similar to the cost plus or resale price methods, except that both benchmark not the gross markup or gross margin of the taxpayer, but instead a measure of net income such as the percentage return on operating capital or on sales, or the ratio of net income to costs. In structure, therefore, the CPM and the TNMM are fundamentally the same.[204]

In tone, the OECD Guidelines express a much higher degree of hesitancy concerning the value of the TNMM than do the U.S. regulations with respect to the CPM. Thus, the OECD Guidelines warn prominently that methods based on net profit, including not

---

[202] Reg. § 1.482-5 ("The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability . . . .").

[203] OECD Guidelines, note 3, app. ¶¶ 3.26-3.48.

[204] See generally Culbertson, Last Resort, note 190, at 382 (concluding that the OECD's change from the CPM to the TNMM is merely a "change of nomenclature").

only the TNMM but also profit split methods, should be used only as a "last resort,"[205] whereas the U.S. regulations establish the priority of methods based on gross income less insistently. Similarly, the Guidelines express much less enthusiastic an invitation than the regulations to apply the new method by reference to a standard of comparability that is reduced from previous conceptions.[206] Overall, therefore, the Guidelines seem to envision a less prominent role for TNMM than the regulations envision for the CPM.

These differences, however, are of little real effect. As explained above, since there is little practical difference between gross income methods such as resale price and cost plus and net income methods such as CPM or TNMM, there is little real significance to the manner in which the regulations or the

---

[205] OECD Guidelines, note 3, app. ¶ 3.50. The Guidelines further warn that "even in a case of last resort, it would be inappropriate to automatically apply a transactional profit method without first considering the reliability of that method." Id.

[206] Id. ¶¶ 3.39-3.57 (explaining various considerations that should be taken into account before applying the transactional net margin method as well as different aspects of comparability).

Guidelines articulate the height of the threshold of comparability required to use one set of methods instead of the other. Similarly, the more stringent tone of the Guidelines concerning the level of comparability required generally, whatever method is selected, is of little fundamental significance. Regardless of the tone used, the question of the acceptability of comparables in any given instance will be highly subjective; local practices, and even such factors as the proclivities of individual revenue agents and taxpayer representatives, are likely to be of more significance than the articulation of standards of comparability in the regulations or Guidelines.

=S4 b. Profit Split Methods Under the Regulations and Guidelines@

Both the U.S. regulations and the OECD Guidelines permit the use of profit split methods if other methods cannot be used. The U.S. regulations are strict in the types of profit splits that they would accept as specified methods, permitting only (1) a comparable profit split based on evidence obtained from actual joint ventures among unrelated parties[207] and which, by the general consensus of observers, is almost never going to be

[207] Reg. § 1.482-6(c)(2).

applicable in practice;[208] or (2) a residual profit split of the kind described in the White Paper.[209] Thus, as a practical matter, the U.S. regulations require a two-step analysis, in which a CPM first is used to apportion routine income, and then residual income is split based on the parties' relative contributions of intangibles.

Perhaps surprisingly, the OECD Guidelines are less restrictive than the U.S. regulations and would permit the use of a wide variety of profit splits, provided they properly divide income based on the parties' historical contributions to the activity in which they are engaged.[210] On their face, profit

---

[208] See, e.g., John P. Warner & Harrison B. McCawley, Transfer Pricing: The Code and the Regulations, 887 Tax Mgmt. (BNA) Portfolio A-143 (1995) (finding it "difficult to envision" circumstances in which comparable profit split method could be used).

[209] Reg. § 1.482-6(c)(3); see Section III.B.3 (discussing the White Paper, profit split methods, and cost sharing).

[210] The relative permissiveness of the Guidelines toward profit splits is consistent with the fact that, during the debate of the late 1980's and early 1990's, far more vituperation was directed at BALRM and its successors, the comparable profit interval of the 1992 proposed regulations and the CPM of the

split methods would appear to invoke much more starkly the danger of formulary apportionment than did BALRM or its successors, so that one might have expected OECD opposition to profit split methods to be especially intense. The real threat of BALRM and its successors, however, was not their resemblance (if any) to formulary apportionment,[211] but instead the fact that Treasury apparently had designed them as a means of facilitating larger scale and more mechanical enforcement,[212] whereas the participants in the debates of the late 1980's and early 1990's do not seem to have perceived profit splits as susceptible to use as a large-scale enforcement tool. Thus, the reaction against profit splits was relatively muted, and the Guidelines in fact remain more open to their use than does the final version of the U.S. regulations.

1993 proposed and 1994 final regulations, than at the notion of profit split methods.

[211] See Section II.C (describing Congress' original invitation for Treasury to consider using formulae in the regulations as a means for facilitating enforcement).

[212] See Section III.2.a (describing one of Treasury's motives in drafting the regulations as based on enforcement).

=S3 3. Cost Sharing Under the Final Regulations and Guidelines@

Both the U.S. regulations and the Guidelines indicate that written cost sharing arrangements that divide costs in a manner commensurate with intended benefits generally should be accepted by tax authorities.[213] The Guidelines generally would let governments adopt cost-sharing rules that are more expansive than the U.S. rules. For example, the U.S. regulations permit cost-sharing agreements only for sharing the cost of developing intangibles,[214] whereas the Guidelines envision the use of cost-sharing agreements in other contexts.[215] As a matter of current practice, different countries' rules vary substantially.[216] What

---

[213] Reg. § 1.482-7(a)(1),(b)(2); OECD Guidelines, note 3, app. ¶¶ 8.8-8.9.

[214] Reg. § 1.482-7(a)(1).

[215] OECD Guidelines, note 3, ¶ 8.7.

[216] See, e.g., Bert van der Klok, The Netherlands' New Transfer Pricing Rules: A Comparison With U.S. Rules and OECD Guidelines, 10 Tax Mgmt. Transfer Pricing Rep. 224 (July 25, 2001) (providing that cost sharing agreements can deal with different types of activities); Heiz-Klaus Kroppen & Achim Roeder, German Cost Sharing Guidelines: An International Comparison, 8 Tax Mgmt. Transfer Pricing Rep. 1000 (Mar. 22, 2000) (referring to how the German and OECD guidelines use cost

remains significant for current purposes, however, is that despite their general insistence on after-the-fact, results-oriented means of enforcing compliance with the arm's length standard, both the Guidelines and the regulations include, and address at some length, an alternative approach to transfer pricing that is based explicitly on an ex ante joint venture model.

In keeping with the approach of the White Paper,[217] neither the U.S. regulations nor the Guidelines seek to integrate cost sharing into the main body of their analyses. Instead, in both sets of rules, cost sharing is confined to separate sections and thus treated as a "thing apart."[218] Nevertheless, in both sets

---

sharing to "allocate centrally incurred administration costs within a group of companies operating internationally[,]" in addition to its use in managing the funding, transfer, or development of intangible property).

[217] White Paper, note 68, at 493 (providing a separate discussion and analysis of cost sharing arrangements).

[218] Reg. § 1.482-7 (explaining the use of cost sharing arrangements); OECD Guidelines, note 3, ¶¶ 6.01-6.05 (providing a separate chapter for cost sharing agreements).

of rules cost sharing remains available, and by all indications the practice remains popular with taxpayers.[219]

---

[219] Indeed, this popularity has now given cost sharing something of a bad reputation among U.S. enforcement officials. A number of large-scale disputes over cost sharing are pending in the United States, and these disputes have occasioned significant strain in the relationship between taxpayers and enforcement authorities. See generally Patricia Gimbel Lewis & Neal M. Kochman, Cost Sharing Arrangements Come of Age, 9 Tax Mgmt. Transfer Pricing Rep. 347 (Oct. 4, 2000) (analyzing controversial developments stemming from cost sharing agreements). The disputes, however, generally do not involve the structure of cost sharing itself, but rather the amounts of buy-in required at the inception of a cost-sharing arrangement. See id.; see also notes 239-241 and accompanying text. **[x]** In this respect, such disputes are not unique to the cost sharing context. The disputes also involve the technical question, which is bound up closely in the peculiarities of U.S. accounting practice, of whether costs associated with employee stock options should be taken into account in determining participants' contributions to cost sharing arrangements. Lewis & Kochman, supra, at 347. Thus, the ongoing U.S. disputes involving cost sharing, while the source of significant current

=S3 4. Permissibility of “Other” Methods@

Following the pattern of the 1968 U.S. regulations,[220] both the Guidelines and the U.S. regulations allow taxpayers to employ methods other than those specifically described in the Guidelines or regulations, when none of the specifically described methods appears appropriate. Both the Guidelines and regulations indicate that such methods (which the U.S. regulations call unspecified methods) should be based on external market data to the extent possible, although neither body of rules sets forth a rigid requirement to this effect.[221]

---

difficulty, do not involve conceptual elements of the joint venture model on which cost sharing is based.

[220] See notes 45-67 and accompanying text.

[221] The U.S. regulations, in accounting for the use of inspection regulations in connection with transfers of tangible property, provide: “[T]o the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced.” Reg. § 1.482-3(e)(1); cf. Reg. § 1.482-4(d)(1) (providing similar language in context of pricing of intangibles). The OECD Guidelines express a similar preference for the use of methods that rely on external comparables, even

=S3 5. "Documentation" Under the Regulations and Guidelines@

While the White Paper's advocacy of benchmarking based on net income touched off a debate that raged for the next six years, the White Paper's proposal that taxpayers be required under pain of penalty to maintain documentation of their transfer pricing policies[222] generated far less controversy. In the United States, the White Paper's twin themes of contemporaneous documentation and enhanced penalties were implemented in documentation and penalty rules under § 6662.[223]

---

when methods other than those generally described in the Guidelines are used. See OECD Guidelines, note 3, app. ¶ 1.70.

[222] White Paper, note 68, at 464-65.

[223] The current form of those rules developed iteratively, through a series of legislative and regulatory developments that built upon each other, and that steadily tightened the connection between documentation requirements and penalties. A legislative enactment in 1990 added the § 6662(e) penalty directed at transfer pricing noncompliance. Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11312(a), 104 Stat. 1388, 1388-454. In 1991 regulations were adopted that established a contemporaneous documentation requirement (and timely submission to the Service) as requirements for a

After an initial period of wariness, the OECD ultimately endorsed the imposition of documentation requirements to promote compliance with the arm's length standard. The Guidelines thus endorse the view that taxpayers should be required to have ready, at the time they file their income tax returns, documentation describing the manner in which they determined their transfer pricing for tax purposes.[224] Further, a number of countries have adopted such rules, and the list appears to be growing steadily.[225]

---

reasonable cause waiver of the penalty. Reg. § 1.6662-1 to -2. Temporary regulations were issued in 1994 in response to 1993 legislation, Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 § 13236(b); 107 Stat. 312, 505, that further enhanced the documentation approach. Temp. Reg. § 1.6662-6T, 59 Fed. Reg. 4791 (Feb. 2, 1994). Final regulations in 1996 provided detailed rules governing the required documentation. Reg. § 1.6662-6(d)(2)(iii), (d)(3)(iii).

[224] OECD Guidelines, note 3, app. ch. V.

[225] Michael J. Tropin, Full Regulatory Regimes Becoming the Norm Worldwide, 10 Tax Mgmt. Transfer Pricing Rep. 767 (Jan. 23, 2002) (discussing documentation requirements of Canada, Australia, South Africa, Germany, the Netherlands, and Poland).

There appears to be consensus among governmental authorities and taxpayers that documentation requirements are having a generally beneficial effect, both in requiring taxpayers to devote greater attention to transfer pricing compliance and in assisting tax authorities in planning during the initial phases of tax examinations.[226] The main significance

[226] In a recent congressionally mandated report, the Service described the results of surveys, of both taxpayers and examiners, of their views of the utility of documentation. See Announcement 2002-40, note 200. The surveys can be faulted methodologically, especially because taxpayer participation was voluntary, and the authors do seem to have attempted to paint a relatively positive picture. Cf. IRS Study May Overstate Compliance With § 6662(e), Former IRS Official Says, 11 Tax Mgmt. Transfer Pricing Rep. 132 (May 29, 2002). It also can be argued, from elements of the IRS report, that documentation is not easing examinations, or reducing conflict, to the extent that might have been desired. See Michael C. Durst & Robert E. Culbertson, How Much Is Enough? Lessons on Transfer Pricing Documentation From the Recent IRS Report, Tax Executive, Sept. 1, 2002, at 419. Nevertheless, while the quality of documentation appears to vary widely, it is the authors'

of the documentation requirement, however, has not arisen from these immediate and apparently beneficial effects. Instead, the significance of the documentation rules arises primarily from the manner in which they have changed the focus of transfer pricing practice from ex post enforcement, on a discretionary basis, to ex ante self assessment on a mandatory basis. As described below, this change has created an administrative setting that differs fundamentally from the environment for which the substantive rules of the regulations and Guidelines were designed.

=S1 IV. Current Practice: Evaluating the Regulations and Guidelines Based on Practical Experience@

=S2 A. An Incomplete Paradigm Shift@

=S3 1. Root of the Dilemma: Conflict Between Ex Ante Procedural Rules and Ex Post Substantive Rules@

The requirement of contemporaneous documentation, in the United States and increasingly around the world, has changed the environment of transfer pricing compliance in a way that the participants of the debates of the late 1980’s and early 1990’s generally do not seem to have foreseen. The documentation

---

experience that both taxpayers and examiners generally considered the documentation to be helpful.

requirement compels all taxpayers with substantial intragroup transactions to articulate the manner in which they applied the applicable transfer pricing rules to all of the taxpayer’s significant intragroup transactions. Thus, the requirement establishes a regime in which large numbers of tax practitioners routinely apply the transfer pricing rules on a high-volume basis, in what must be, as a practical matter, a somewhat mechanical fashion. Moreover, the availability of the documentation to tax authorities makes it much more likely than before that transfer pricing issues will arise in examinations, so that enforcement as well as compliance is likely over time to become an enterprise of much larger scale than it has been in the past.

The documentation requirement therefore establishes via a procedural route precisely the kind of environment that the prevailing parties in the OECD debates attempted to avoid through their articulation of substantive rules.[227] The resulting practical discontinuity is so fundamental that it would be comical were it not so troubling. Because the substantive rules arose in what the drafters apparently believed was a successful effort to avoid an approach to transfer pricing enforcement that could be widely or routinely applied, the

[227] See OECD Guidelines, note 3, app. ch. V.

substantive rules are by design unsuited to the task to which taxpayers and tax authorities must apply them in a documentation-based system.

Remarkably, neither side of the transfer pricing debates seems to have foreseen this difficulty at the time the OECD Guidelines and the U.S. regulations were negotiated.[228] The

---

[228] Indeed, the only explicit recognition in the U.S. regulations of the new world is the limited acknowledgment, in Reg. § 1.482-1(a)(3), that taxpayers must be permitted to report arm's length results even if those results differ from their initial transactional terms. Reg. § 1.482-1(a)(3). Historically, in keeping with the view of the transfer pricing regulations as an anti-abuse tool to be applied in limited circumstances by the tax administrator, taxpayers arguably were forbidden from reporting anything other than their transactional results. See generally Robert E. Culbertson, Speaking Softly and Carrying a Big Shtick: The Interplay Between Substantive and Penalty Rules in the U.S. Transfer Pricing Regulations, 11 Tax Notes Int'l 1509, 1520 (Dec. 4, 1995) (highlighting, in part, the inconsistent manner in which the 1990 amendment to § 6662(e) penalized taxpayers for neglecting to correct their transactional prices, while the regulations prevented taxpayers from making such corrections).

difficulties, however, have become impossible to ignore, particularly in the United States, as both private and governmental practitioners have confronted the need to deal with the documentation requirements under the constraints of filing deadlines and the threat of substantial penalties,[229] but without the benefit of guidance that was constructed with awareness of the practical difficulties that they face.

Much of the remainder of this Article is devoted to identifying particular respects in which existing rules fail to meet the needs created by the requirement of ex ante documentation. We then suggest improvements that are deliberately intended to be incremental, in that they are designed to reduce compliance costs and other drawbacks of current practice without challenging the political balance that the resolution of the recent debates seems to suggest.

Before we take up those practical suggestions, however, it may be useful to pause briefly to offer some elements of a conceptual framework that might help bridge the gap between the new ex ante procedural environment that the rules establish and the ex post substantive approach that the rules retain. The following comments do not forge new conceptual ground. They suggest, however, that transfer pricing rules, even as

---

[229] See IRC § 6662(a),(b); Reg. § 1.6662-1, -2.

historically conceived, already incorporate a view of the arm's length standard that is broader than the ex post, comparables-based model that participants in the recently completed debates seem often to have presupposed. Greater acceptance of the broader conception can facilitate adoption of the incremental changes that to us seem necessary if the current regulatory regime is to function in a reasonably satisfactory manner.

=S3 2. The Joint Venture Component of the Arm's Length Standard[230]@

The traditional ex post conceptualization of the arm's length standard envisions commonly controlled entities as operating normally in isolation from one another, coming together occasionally in order to effect discretely identifiable transactions. Such a view may have conformed reasonably well to reality with respect to most commonly controlled groups in the first half of the last century.[231] Such groups probably did view affiliates largely as autonomous entities, interacting with one

---

[230] See generally Robert E. Culbertson, Is There a Formula in Your Future? Formulary Apportionment, The Arm's-Length Principle, and the Future Role of Profit Splits, 5 Tax Mgmt. Transfer Pricing Rep. 557, 564-67 (Jan. 15, 1997).

[231] See notes 9-32 and accompanying text.

another on a transactional basis. Even today, commonly controlled groups on the more decentralized end of the managerial spectrum may conform tolerably well to this model.

Many groups today, however, are far more integrated than typically was true in the past.[232] Members of these groups, if they are managed effectively, operate on the assumption that they are engaged in an ongoing relationship and share the long-term goal of joint profit maximization.[233] Pricing among the members of such groups will not be subject to the same market factors that influence the pricing of transactions among unrelated entities.[234]

This does not mean, however, that the relations among the members of such groups cannot be evaluated by reference to the arm's length standard. Business presents countless instances in which entities that are not under common ownership enter into long-term cooperative relationships. Some of the most paradigmatic examples are provided by explicit partnerships and similar joint ventures, but the phenomenon extends much more broadly to encompass such arrangements as alliances, co-

---

[232] See notes 107-113 and accompanying text. **[x]**

[233] See text accompanying note 133.

[234] See text accompanying notes 140-141. **[x]**

marketing arrangements, long-term supply arrangements, and a variety of others.

Such long-term relationships among unrelated entities are subject to the constraints of the market to the same extent as are occasional transactions between entities that normally operate independently. At arm's length, parties acting rationally enter into such arrangements only if, at the inception of the arrangement, each party expects to achieve an acceptable return on the costs that it commits to the arrangement, in view of the participant's anticipated risks. This criterion constitutes an arm's length standard in its most fundamental form.

Although participants in transfer pricing debates, including the recently concluded debates, generally have not focused on this point, the fact is that transfer pricing rules for many years have incorporated this conception of the arm's length standard, which might for shorthand purposes be called the "joint venture model."[235] Incorporation of the joint venture model is evidenced most explicitly by the notion of cost sharing, but the model inheres as well in profit split approaches.

---

[235] See notes 142-145 and accompanying text. **[x]**

The joint venture model has a special appeal under traditional views of income taxation in that the model conforms to the "matching principle," under which a taxpayer's income subject to taxation normally should be matched against deductions allowed to the same taxpayer.[236] In the setting of international tax administration, this notion can be expressed as the principle that the income that is taxable in a particular jurisdiction should be matched against the deductions that historically were allowed in that jurisdiction. This concept is rarely invoked explicitly in discussions of transfer pricing, but it seems impossible to avoid if the topic is to be considered comprehensively.

In the international setting, the matching principle has macroeconomic as well as microeconomic appeal. All income-

---

[236] The principle is perhaps most plainly evident in cases involving the matching of transactions that occur in different time periods, e.g., Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370, 381-83 (1983); Arrowsmith v. Commissioner, 344 U.S. 6, 8-9 (1952), but it pervades the notion of net income generally. Cf. Diane M. Ring, Risk-Shifting Within a Multinational Corporation: The Incoherence of the U.S. Tax Regime, 38 B.C. L. Rev. 667, 699 (1997) (referring to "related party matching principles").

producing activities can be seen as a series of deductible costs followed, with varying degrees of probability, by resulting income, including in some cases zero income or income lower than the costs incurred (losses). Different deductions produce different probabilities of generating income or loss, and in varying amounts. Overall, however, taking into account the successes and failures of many activities and many different taxpayers, a country should achieve a "normal" overall return on deductions incurred in the jurisdiction, and thus should generate its appropriate income tax base. If, however, applicable rules permit deductions from an activity to be taken in one jurisdiction and associated income or loss to be booked for tax purposes in another jurisdiction, the tax base of one country is likely to be depressed at the expense of the other. The matching principle thus serves well as a criterion of intergovernmental equity under a transfer pricing system.

The model provided by current cost sharing rules has the additional merit of incorporating the requirement of a written ex ante agreement, in which the participants must explain the basis on which their arrangements can be expected to conform to the matching principle. The model thus offers the promise of avoiding the overwhelming evidentiary issues that arise under ex post approaches to transfer pricing enforcement, under which the tax authority is left, for example, with the task of

reconstructing retrospectively whether a taxpayer in fact conformed to the one-sided functional paradigm on which BALRM-like approaches are based. At least potentially, therefore, the joint venture model would help address the problems posed by the new ex ante documentation requirements.

A wide variety of arrangements, if properly documented on an ex ante basis and then followed consistently, can conform to the matching principle. The range extends from BALRM-style one-sided arrangements, in which one party agrees to perform specified services on a limited-risk basis while the other bears most of the entrepreneurial risk, to fully mutual arrangements, such as those established by paradigmatic cost sharing agreements. The joint venture model therefore does not suggest any limitation on the flexibility of taxpayers' arrangements.

This is not to suggest that the cost sharing approach and the broader joint venture model, of which cost sharing is an example, do not face significant practical problems. The White Paper, while not exploring the potentially broader application of cost sharing principles, gives these problems detailed attention,[237] and we note them here.

Perhaps the least serious difficulty of the cost sharing approach, and of the joint venture model that underlies it, is

[237] White Paper, note 68, at 495-500.

that concerted activity by separate legal entities raises the possibility of partnership characterization, which can have troubling administrative and substantive implications under international tax rules as they historically have been applied. Indeed, one function of cost sharing provisions in current transfer pricing rules is to assure participants that by taking part in such arrangements they are not acting as partners for tax purposes.[238] The problem is likely to present itself, if only as a source of worry to taxpayers, under any expansion of the cost sharing model in the transfer pricing system, and thus would need to be addressed as a threshold matter.

A more serious problem of the joint venture model is what has become known as the "buy-in" issue.[239] The buy-in issue

---

[238] Reg. § 1.482-7(a)(1) (specifying that participation in a qualified cost sharing agreement does not in itself establish a partnership or cause a foreign corporation or nonresident alien participant to be engaged in a trade or business in the United States); OECD Guidelines, note 3, app. ¶ 8.3 (cost sharing arrangement does not in itself result in permanent establishment or create legal entity).

[239] The term originated in the cost sharing rules, although as discussed immediately below the concept has wide application. Cf. Reg. § 1.482-7(g)(2) (requiring payment of "buy-in" when

arises from the possibility that particular deductions—notably, deductions incurred in successful attempts to develop valuable intangibles—might generate income that is disproportionate to the costs that were deducted. Under transfer pricing rules based on a matching of income against prior deductions, parties might face a temptation to attribute ownership of valuable intangible property to parties that did not in fact bear the cost of the properly associated deductions. This would violate the matching principle and, where effective tax rates differ substantially between jurisdictions, could result in significant tax avoidance.

In the cost sharing regulations, the buy-in issue is addressed by the requirement that parties contributing pre-existing intangible property to the cost sharing pool—that is, property attributable to deductions that were not shared among the members of the pool—must receive arm's length payment for providing the property.[240] In practice, such buy-in issues have generated persistent, large-stakes disputes under existing cost

---

participant brings pre-existing intangibles to cost sharing arrangement).

[240] Reg. § 1.482-7(g)(2).

sharing rules, and a resolution of existing controversies in this area is nowhere in sight.[241]

The buy-in problem, however, if properly understood, should not dissuade governments from considering a greater role for the joint venture model in transfer pricing regulations. The reason is that the buy-in problem is not specifically a creature of cost sharing or of the broader joint venture model, but is raised under any transfer pricing model when a multinational business changes the nature of its intercompany business relationships from prior patterns.

Consider, for example, a manufacturing affiliate that seeks to apply a CPM-style, one-sided transfer pricing method in a given year. The tax authority of the affiliate's jurisdiction may well wish to inquire whether the operation has consistently operated under the limited-risk, stable return model underlying the method, or whether in the past the affiliate bore the risk of expenses that created valuable manufacturing intangibles for which the affiliate should be compensated. Similar issues are likely to arise when an entity claims treatment as a limited-risk distributor. Such issues (sometimes referred to, particularly in Europe, as issues concerning alleged transfers of goodwill) are extremely common in transfer pricing practice;

---

[241] See generally Lewis & Kochman, note 219.

they are in no way unique to cost sharing. Transfer pricing rules should provide means of mitigating disputes over such issues regardless of the transfer pricing methods that the rules incorporate.

Another problem commonly associated with cost sharing relates to what economists dealing in the field of insurance typically refer to as adverse selection,[242] and which in transfer pricing parlance is referred to as cherry-picking. While in theory cost sharing is an "even bet," under which in the aggregate successes and failures will balance so that income earned by a participant is matched economically by the participant's deductions, in fact multinational groups may have special insight into the likely success or failure of particular ventures. Entities in high-tax jurisdictions thus might be tempted to assign to cost sharing arrangements only those activities with particularly high chances of success.

Cherry-picking is indeed a potentially vexing problem under cost sharing rules but, like the buy-in issue, any notion that it arises only from cost sharing, or from approaches similarly based on a joint venture model, is illusory. Generally, in today's international income tax system, regardless of the

---

[242] See Emmett J. Vaughan & Therese M. Vaughan, Fundamentals of Risk and Insurance 28-29 (7th ed. 1996).

transfer pricing method that the members of a multinational group employ, the group faces an incentive to locate what it expects to be its most promising activities in low-tax jurisdictions. This is a topic of significant concern in tax policymaking,[243] but it is only tenuously connected with transfer pricing methods. Cherry picking, while a serious issue, does not provide a reason for avoiding the joint venture model.

Another problem sometimes associated with the joint venture model generally, if not with cost sharing specifically, is the deference the model requires to the parties' intragroup written arrangements, the bona fides of which may be subject to government questioning. It is indeed true that intragroup contracts deserve deference for transfer pricing purposes only if they conform to the arm's length standard, in the sense that the risks undertaken by a particular party are commensurate with that party's potential rewards. It is also true that commonly controlled entities face no overall constraints that would compel them to adopt only agreements that meet this standard. Thus, it is necessary to police the arm's length nature of

---

[243] See, e.g., Treasury Dep't News Release and Preliminary Report on Tax Policy Implications of Corporate Inversion Transactions, Daily Tax Rep. (BNA), May 20, 2002, at L-3.

intragroup agreements rather than accord them automatic deference.

The problem of verifying the arm's length nature of intragroup agreements is not fundamentally different, however, from that of retrospectively examining their functions and risks to determine how their income should be distributed under the arm's length standard. As a practical matter, however, the presence of intragroup agreements makes the tax authorities' task easier,[244] since an agreement provides a standard on which an examination can be based, whereas in the absence of an agreement the tax authority faces a potentially infinite number of functions and risks to address. The dependence of the cost sharing approach on written intragroup agreements therefore does not constitute a reason for avoiding the approach; to the contrary, it is one of the approach's advantages.

=S2 B. Particular Areas of Difficulty With the New Rules@

Recognition of the disparity between the new rules' ex ante procedural focus, and the ex post assumptions that largely underlay their substantive components, helps to identify the particular elements of the new rules on which attention should be focused if effective incremental improvements are to be made.

---

[244] See notes 273-295 and accompanying text. **[x]**

These areas include: (1) the differing, but similarly unsatisfactory, attempts of the Guidelines and regulations to provide practical guidance for identifying and applying data from comparables, (2) the grudging manner in which both the Guidelines and the regulations address the potential benefits of ex ante written agreements among commonly controlled entities, and (3) the aversion of both the Guidelines and the regulations to the provision of safe harbors.

=S3 1. Different Pathways Into the Same Wilderness: The Evaluation of Comparables Under the Guidelines and Regulations@

A key component of the guidance offered by the OECD Guidelines and the U.S. regulations is the process of selecting and evaluating comparables. While the two documents are generally consistent in their approaches, there are distinct differences of emphasis that seem to be broadening in practice. Neither document, however, provides an approach that is likely to be effective in a documentation-based environment.

=S4 a. The Guidelines: Factual Inquiry Is Essential, But No Amount Could Possibly Be Adequate@

The OECD Guidelines, adopting with relish the approach of the 1968 U.S. regulations criticized by James Eustice,[245] consist to an almost astonishing extent of (1) lengthy enumerations of factors that must be taken into account in performing a proper functional analysis of the circumstances surrounding each set of controlled transactions, and (2) stern warnings against any attempt to infer generally applicable rules that might reduce the need for detailed factual inquiry in each specific case. The overall image created is that the notion that transfer pricing analysis could be simplified in a manner that would permit its large scale application is a demon that must be warded off with repeated verbal incantations.

For example, the introduction to the topic of functional analysis in the Guidelines lists, simply by way of example, 12 different functions that should be analyzed.[246] A later

---

[245] See note 63 and accompanying text.

[246] OECD Guidelines, note 3, app. ¶ 1.21. The OECD Guidelines indicate that:

=xt

> The functions that taxpayers and tax administrations might need to identify and compare include, e.g., design, manufacturing, assembling, research and development, servicing, purchasing, distribution,

discussion of one element of functional analysis—a review of economic circumstances surrounding particular transactions, lists eight factors, several of which have numerous subfactors, as well as the words "and so forth," thus emphasizing that even the extensive list provided is not intended to be exhaustive.[247]

> marketing, advertising, transportation, financing, and management. The principal functions performed by the party under examination should be identified. Adjustments should be made for any material differences from the functions undertaken by any independent enterprises with which that party is being compared. While one party may provide a large number of functions relative to that of the other party to the transaction, it is the economic significance of those functions in terms of their frequency, nature, and value to the respective parties to the transactions that is important.

=ft
Id. app. ¶ 1.21.

[247] Id. app. ¶ 1.30. The Guidelines provide that:

=xt

> Arm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate are comparable, and that differences do not have a material effect on price or that appropriate adjustments can be made. As a first step, it is essential to identify the relevant market or markets taking account of available substitute goods or services. Economic circumstances that may be relevant to determining market comparability include the geographic location; the size of the markets; the extent of competition in the markets and the relative competitive positions of the buyers and sellers; the availability (risk thereof) of substitute goods and services; the levels of supply and demand in the market as a whole and in particular

Similar lists, or language requiring reference to large volumes of facts, appear throughout the Guidelines.[248] Also, and in a variety of contexts, the Guidelines stress repeatedly that in no instance can generally applicable principles be distilled and applied, but that transfer pricing analysis is legitimate only if it is based in each instance on exhaustive analysis of the facts and circumstances.[249]

---

regions, if relevant; consumer purchasing power; the nature and extent of government regulation of the market; costs of production, including the costs of land, labour, and capital; transport costs; the level of the market (e.g. retail or wholesale); the date and time of transactions; and so forth.

=ft
Id. app. ¶ 1.30.

[248] See, e.g., id. app. ¶ 2.25 (listing functions that might be relevant to resale price analysis); ¶ 2.38 (requiring detailed analysis of functions in applying cost plus method), ¶ 6.7 (listing different marketing activities that might be relevant to the prices of intangibles); ¶ 6.21 (listing factors relevant to analysis of patents); ¶ 7.32 (suggesting that detailed functional analysis of different participants may be required in evaluation of intragroup services arrangements).

[249] See, e.g., id. app. ¶ 1.16 ("In all cases adjustments must be made to account for differences between the controlled and uncontrolled situations that would significantly affect the

The discussion of the "arm's length range" further illustrates the Guidelines' approach. The concept of an arm's length range was first developed in connection with the White

---

price charged or return required by independent enterprises."); ¶ 1.69 ("[A]n attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration."); ¶ 1.70 ("It is not possible to provide specific rules that will cover every case." and "It should not be the case that useful information, such as might be drawn from uncontrolled transactions that are not identical to the controlled transactions, should be dismissed simply because some rigid standard of comparability is not fully met."); ¶ 6.15 (highlighting "the importance of taking all the facts and circumstances into consideration when determining comparability of transactions"); ¶ 6.17 (describing the need for care in addressing transactions jointly involving tangible and intangible property, and warning that a resolution must "depend very much upon the circumstances of each deal and there would appear to be no general principle which can be applied except that there should be no double deduction . . . ").

Paper's notion of using statistical methods to benchmark returns under BALRM,[250] and subsequently extended by the temporary U.S. regulations from the CPM to all methods.[251] As described below, the regulations attempt (albeit in ways that have proved problematic) to provide discipline to the notion of the arm's length range by articulating quantitative criteria.[252] In contrast, the Guidelines describe a range that is based entirely on judgment arising from the broadly defined facts and circumstances inquiry that the Guidelines generally envision.[253]

---

[250] See White Paper, note 68, at 488.

[251] Temp. Reg. § 1.482-1T to -5T, 58 Fed. Reg. 5263 (Jan. 21, 1993).

[252] See notes 254-270. **[x]**

[253] OECD Guidelines, note 3, app. ¶ 1.45. This paragraph provides that:

=xt

> [B]ecause transfer pricing is not an exact science, there will also be many occasions when the application of the most appropriate method or methods produces a range of figures all of which are equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between independent enterprises. It is also possible that the different points in a range represent the fact that independent enterprises engaged in comparable transactions under comparable circumstances may not establish exactly the same price for the transaction. However, in some

On the other hand, the Guidelines do not seem to entertain any real illusion that in practice, either taxpayers or revenue authorities can take into account the enormous volume of factual items that reasonably might be expected to affect market prices even in relatively simple business situations. Instead, what the Guidelines seem to envision—indeed, to advocate—is a return to historical patterns in which transfer pricing examinations were relatively low-key affairs, and resolutions were negotiated effectively on a gestalt basis:

=xt

[F]or difficult cases, where no approach is

---

cases, not all comparable transactions examined will have a relatively equal degree of comparability. Therefore, the actual determination of the arm's length price necessarily requires exercising good judgment . . .[U]se of a range may be particularly appropriate where, as a last resort, the transactional net margin method is applied.

=ft
Id. app. ¶ 1.45.

Similarly, the Guidelines say that "[n]o general rule may be stated with respect to the use of ranges derived from the application of multiple methods because the conclusions to be drawn from their use will depend on the relative reliability of the methods employed to determine the ranges and the quality of the information used in applying the different methods." Id. app. ¶ 1.46.

> conclusive, a flexible approach would allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint to all the parties involved, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration.[254]

=ft

This passage seems to recall the historically relaxed transfer pricing environment that foreign governments, during the debate of the late 1980's and early 1990's, essentially were trying to defend against U.S. attempts to introduce a more aggressive system of enforcement. The repeated insistence on facts and circumstances under the Guidelines thus can be seen as an attempt to retain then-existing patterns of enforcement.

The difficulty, of course, is that this approach provides precious little guidance to taxpayers who currently are required, under threat of penalty in multiple jurisdictions, to articulate their transfer pricing analyses in a convincing manner.[255] In practice, such taxpayers face a choice either of lengthy, open-ended, and ultimately unsatisfying verbal excursions similar to those of the Guidelines' own articulation of the analytical process, or else, as a last resort, adoption

---

[254] Id. app. ¶ 1.69.

[255] See notes 223-225 and accompanying text. **[x]**

of a statistical approach modeled on that of the U.S. regulations–an approach that, as shown immediately below, is not yielding satisfactory analyses under current practice.

=S4 b. The U.S. Regulations, Computerized Databases, and the Interquartile Range: Trying With Statistics@

Like the Guidelines, the U.S. regulations enumerate many different kinds of facts and circumstances that must properly be taken into account in evaluating the suitability of potential comparables.[256] In dealing, however, with the likely uncertainty of being able to determine which of a group of potentially applicable but inevitable imperfect comparables is best, the U.S. regulations seek to preserve some measure of the White Paper's statistical approach to the determination of an arm's length range.

The regulations first provide that, if all of the comparables that have been identified with respect to the set of controlled transactions under consideration are very close in functions and risks to the controlled transactions (after taking into account any relatively straightforward adjustments that can be made to compensate for any differences), all the comparables

[256] See, e.g., Reg. § 1.482-3(b)(2)(ii)(B), (c)(3)(ii)(C), (d)(3)(ii)(C).

can be taken into account in establishing an arm’s length range, without further statistical analysis.[257]

If, however, the comparables (even with adjustment) cannot be considered very close in functions and risks to the transactions under consideration, then

=xt

> the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all the uncontrolled comparables . . . [that have been] selected. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however

---

[257] Reg. § 1.482-1(e)(2)(iii)(A). This regulation provides that:

=xt

> The arm’s length range will consist of the results of all of the uncontrolled comparables that meet the following conditions: the information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is likely that all material differences have been identified, each such difference has a definite and reasonably ascertainable effect on price or profit, and an adjustment is made to eliminate the effect of each such difference.

=ft

a different statistical method may be applied if it provides a more reliable measure.[258]

=ft

The regulations' invocation of statistical methods to increase the reliability of the analysis harks back to the White Paper's overall skepticism about the reliability of comparables, and its reliance on a broad-based sample of arm's length returns as a benchmark.[259] By the time of the final regulations, however, Treasury, in the face of a great deal of opposition, had retreated from the very broadly based notion of comparables that the White Paper had adopted. Thus, the drafters of the final regulations faced the likelihood that the sample sizes of comparables that would be identified under the regulations would be much smaller than the sizes that the drafters of the White Paper apparently had assumed.

Recognizing the potential difficulties of small sample sizes, the final regulations broadened, relative to prior proposals, the ability to make use of inexact comparables under all methods.[260] It remained apparent, however, that sample sizes

---

[258] Reg. § 1.482-1(e)(2)(iii)(B).

[259] See Subsection III.B.1.

[260] The preamble to the final regulations says that the use of statistical techniques to define the arm's length range "has been extended to all methods under the final regulations to

often would be too small to permit the use of standard statistical measures of variation such as the standard deviation, which rely explicitly on various assumptions that are justified only in cases of relatively large sample size.[261] Thus, the regulations adopted the less commonly used[262] measure of the interquartile range.

The language of the regulation suggests that the drafters struggled with the difficulty of prescribing a statistical approach in a setting where the volume of data needed to support valid statistical analysis was unlikely to be available. Thus, the drafters provided that the interquartile range should be used "where it is possible,"[263] perhaps hoping to leave open the interpretation that statistical analysis should be eschewed entirely in the event of very small sample sizes. This interpretation, however, is contradicted by the fact that the regulations themselves contain examples suggesting that a sample

---

reflect the fact that the standards of comparability have been relaxed to permit the use of inexact comparables." T.D. 8552, 1994-2 C.B. at 102.

[261] See notes 269-270 and accompanying text. **[x]**

[262] See notes 269-273 and accompanying text. **[x]**

[263] Reg. § 1.482-1(e)(2)(iii)(B).

size of only four may be sufficient to establish an interquartile range.[264]

The interquartile range quickly became a fixture of U.S. transfer pricing practice. For many companies, contemporaneous documentation for U.S. purposes has become a matter of determining a "tested party"—that is, the entity within the group that conforms most closely to the routine, limited-risk paradigm underlying CPM—and then performing a search for comparables from compilations of data reported to the SEC by publicly traded companies. Typically, the search begins by identifying several hundred companies in a relatively broad Standard Industrial Classification category into which the tested party appears to fit. Then, typically following a predetermined pattern, the person performing the search applies various "screens"—that is, eliminating companies with

---

[264] Reg. § 1.482-1(e)(5) (Exs. 2 & 3). The regulations also suggest that statistical measures other than the interquartile range may be employed if they provide a "more reliable measure." Reg. § 1.482-1(e)(2)(iii)(B). The intent of this language is unclear; it would seem simply to underscore that in many circumstances, the regulations' preferred measure, the interquartile range, is not reliable under normal standards of statistical reliability.

specifically identified R&D expenditures above a certain level, companies with repeated losses, and companies differing greatly in size from the tested party—in order to narrow the list of potential comparables.

The person performing the search then reads the detailed descriptions of the companies on the narrowed list that are contained in SEC disclosure statements, and on the basis of this reading applies subjective judgment to select a final list of comparables. The Service, as well as private practitioners, applies this method in a large number of cases on an everyday basis; the IRS APA Program has published detailed training materials describing this approach,[265] and IRS personnel outside the APA Program also apply it routinely.

---

[265] The APA training materials are reprinted at Excerpts From Advanced Pricing Agreement Program's New Hire Training Materials, 10 Tax Mgmt. Transfer Pricing Rep. 462 (Oct. 31, 2001). Instructions for the identification and adjustment of comparables are found at Excerpt F: Presentation on Selecting Comparables, 10 Tax Mgmt. Transfer Pricing Rep. 492 (Oct. 31, 2001), and Excerpt O: Case Analysis and Fact Development, 10 Tax Mgmt. Transfer Pricing Rep. 494 (Oct. 31, 2001).

In broad outline the approach used conforms to that envisioned by the authors of the White Paper,[266] but in practice the situation is quite different. As noted, the White Paper apparently anticipated that the final set of comparables in a given instance would contain enough statistically independent data points to permit application of standard statistical methods in determining, from the data, an arm's length range. Such recognized methods typically depend on the well-accepted observation that large sets of data from statistically independent observations tend to be distributed in a "normal" (for example, bell-curve) fashion on either side of a central point, with a characteristic tailing off of the frequency of observations as the distance from the central point increases.[267]

---

[266] See notes 126-127 and accompanying text. **[x]**

[267] All statistical analysis depends on the assumption that the shapes of distinctions become predictable as sample size increases. Much of statistical technique depends on determining quantitatively, the extent to which a particular statistical inference can be considered reliable, given the particular sample size used in reaching the inference. See, e.g., M.G. Bulmer, Principles of Statistics 120 (2d ed. 1967); Paul Newbold, Statistics for Business and Economics 237-47 (3d ed. 1991).

Using this model, it becomes possible, using various statistical methods, to judge according to widely accepted criteria whether any particular observation deviates significantly from the central tendency. As noted above, however, given the small sample sizes that could arise in the context of a comparability-driven CPM, the regulations identified the interquartile range as a method that can apply to small samples.[268]

Although we understand the government's interest in imposing some discipline on the establishment of a range using inexact comparables, and thus understand the invocation of statistical techniques in the context of relatively large sample sizes, we are not convinced that the statistical approach makes sense when sample sizes are very small.[269] It is our experience

---

[268] Cf. Bulmer, note 267, at 56 (noting that, because interquartile range does not rest on large-sample models with predictable underlying distinction, "[i]n practice, . . . statisticians almost invariably use" the standard deviation instead of the interquartile range).

[269] Although the particular sample size reached in order to obtain a reliable estimate from statistical analysis varies according to the circumstances, there is, as a practical matter, a minimum size that is useful for any kind of statistical analysis. Cf. Chris Chatfield, Problem Solving: A

that when a handful of comparables is involved in the analysis, meaningful distinctions can be drawn that permit the taxpayer to be more closely identified with some subset of the comparables, and that resorting to the purely mechanical computation of an interquartile range in such circumstances is relatively likely to produce implausible results. This follows from the fact that there is no theoretical reason to view the range identified under this method as conferring any degree of confidence that data within the range is or is not normal.

Indeed, in our experience application of the interquartile range to small samples often results in the creation of a range that is too wide to be of practical use in resolving cases. Sample sizes in fact tend to be small; while relatively few studies in our experience narrow the comparables to a sample as small as four, sample sizes of less than ten are common. As

---

Statistician's Guide 15 (2d ed. 1995) ("With measured variables, a sample size of about 20 is usually a working minimum which can always be increased if necessary.") The current U.S. regulations contain an example indicating that a sample size of only four might be sufficient in order to construct an interquartile range. Reg. § 1.482-1(e)(5) (Ex. 3). An analysis based on a sample size that small cannot be said to rely on standard statistical techniques. See Chatfield, supra, at 10.

would be expected given the wide ranges of results that even very similar businesses experience in practice,[270] the resulting ranges tend to be extremely wide, often ranging from low negative numbers (for example, a net operating margin of –2%) to relatively high positive numbers (for example, a net operating margin of 8.5%).

As a practical matter, such a range is not likely to prove satisfying to an examiner in those cases in which the taxpayer's pricing system is selected for examination. If the taxpayer's actual results appear subjectively incorrect to the examiner, he or she can feel bound professionally to attack the range, generally by following the implicit invitation of the regulations to look closely at the functional analysis the taxpayer used in selecting comparables. In view of the subjectivity that must be employed in selecting among very imperfect comparables, it generally is not hard to make a credible case that one or more comparables should be removed or added; and given the small sample sizes, the addition or deletion of one or two comparables can cause very large swings in the range. The result, even in a relatively simple case, can be a battle between technical personnel of the taxpayer and the

[270] See note 249.

government extending over several years, with no clear standard to be used in resolving the dispute.

The resulting need for a massive expenditure of enforcement resources to address even a single, simple case limits the number of situations that the Service in fact addresses. The result from the taxpayer's perspective is a system in which the Service's decision to initiate a serious transfer pricing examination seems largely random, and the price of being selected for such an examination is to be subject to an expensive and surrealistic process of argument between economists over arcana of database searches, asset intensity adjustments,[271] and the like, which even nonspecialized personnel

[271] The regulations, probably to an extent that was unintended, have added to the complexity of current statistical approaches by requiring that CPM analysis include adjustments to data, commonly referred to as asset intensity adjustments, to reflect differences between particular balance sheet items of the tested party and the comparables that have been selected. See Reg. § 1.482-5(c)(2)(iv),(e) (Exs. 5 & 6). The general notion underlying the requirement of adjustments is that a company's maintenance of unusually high levels of particular categories of capital indicates that the company is providing additional levels of service to its customers for which, in a competitive

market, the company should receive additional compensation. See Reg. § 1.482-5(a), (b). For example, if a company holds a level of inventory relative to sales higher than the levels of comparable companies, the company holding the excess inventory is assumed to be performing the service of rendering product more accessible to customers, thus justifying higher compensation. Similarly, a company with an unusually high level of accounts receivable is assumed to be providing relatively easy credit terms to its customers, thus justifying a higher level of income in a competitive market. Cf. APA Training Materials, note 265, at 40 **[Check]** ("Two concepts underlie the need for asset intensity adjustments. [T]he first is that the amount of capital actively employed in a business normally affects a company's economic profit and expected return. The second is that hidden interest included in a company's expenses or revenues should be removed."); id. at 45 (describing software used to apply asset intensity adjustments).

The problem, however, is that a high level of inventory, for example, need not signify any reason to expect a higher level of income; it is equally (perhaps more) likely in any given instance that an abnormally high level of inventory indicates that a company is having difficulty selling its product, a fact that would be associated with low, not high,

of the taxpayer soon begin to suspect represents little more than wheel spinning.[272] Government enforcement personnel, from their perspective, find themselves bound to participate in a system that transparently makes ill use of their training and abilities.

---

income. Similarly, a company with a high level of accounts receivable may simply be having unanticipated difficulties in collection—again a factor that is likely to lead to lower, not higher income, contrary to what the practice of asset intensity adjustments seems to assume. (The authors are grateful to J. Gregory Ballentine for discussion of this point.) It seems unlikely that the requirement of asset intensity adjustments adds substantial accuracy to the evaluation of uncontrolled comparables; to the contrary, the requirement probably adds complexity and cost with little benefit in return.

[272] Hubert Hamaekers, Arm's Length-How Long?, in International and Comparative Taxation, Essays in Honour of Klaus Vogel 29, 44 (Kees van Raad ed., 2001) (expressing the view that "[t]he new specialty of 'comparables experts' is a concrete example of . . . economic waste"); Cf. Matthew Bishop, The Economist Survey: Globalisation and Tax: Gimme Shelter, The Economist, Jan. 29, 2000, at S18 (describing how multinationals "spend a fortune" to justify their transfer prices).

A less technical but nevertheless serious concern is that current practices relating to a comparables search and the construction of an interquartile range have affected the dynamics of dispute resolution by giving an appearance of scientific method to what is in fact a subjective analysis. This appearance of scientific method can make it much harder to resolve cases: As a psychological matter it is far easier to compromise over differences of acknowledgedly subjective viewpoint than to admit shortcomings in analyses that one is compelled to present as objective.

=S3 2. Ex Ante Contracts Under the Regulations and Guidelines@

=S4 a. Ex Ante Agreements in General@

Both the U.S. regulations and the OECD Guidelines, in contrast to the general silence under the 1968 regulations, indicate that in determining the facts and circumstances on which transfer pricing enforcement will be based, enforcement authorities should respect ex ante contracts made among the members of commonly controlled groups provided that the contracts are commercially sensible and the parties observe them consistently. Thus, the regulations provide: "The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic

substance of the underlying transactions."[273] The regulations provide as well that "the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction."[274] Similarly, the OECD Guidelines state that in reviewing a taxpayer's activities "an analysis of contractual terms should be a part of the functional analysis."[275]

Both the regulations and the Guidelines note that, as a practical matter in transfer pricing enforcement, if the parties to controlled transactions have not actually evidenced their intent through a written contract, enforcement authorities are placed in the position of needing to infer such a contract. The regulations thus provide that "[i]n the absence of a written agreement, the district director may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction."[276] Similarly, the Guidelines say that "[w]here no written terms exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern

[273] Reg. § 1.482-1(d)(3)(ii)(B)(1).

[274] Reg. § 1.482-1(d)(3)(iii).

[275] OECD Guidelines, note 3, app. ¶ 1.28.

[276] Reg. § 1.482-1(d)(3)(ii)(B)(2).

relationships between independent enterprises."[277] Both the regulations and the Guidelines therefore provide potentially useful reminders that "functional" analysis is in large part actually contractual analysis, and that taxpayers, by maintaining systems of clearly stated intragroup contracts, in many instances might reduce the uncertainty that they otherwise might face in transfer pricing examinations.[278]

Indeed, having a commercially reasonable contract in effect from the beginning of an intragroup arrangement, and abiding by the contract, limits the need for after-the-fact "functional analysis" to the relatively easy question whether the compensation earned actually coincided with the arrangement. Normally, functional analysis requires costly inquiry into which party bore the risks of such functions as, for example, warranty claims, currency fluctuations, marketing mistakes, inventory overruns, and the like. If, however, a contract provides in a commercially reasonable manner that particular parties will bear the costs of particular functions and in return will receive

---

[277] OECD Guidelines, note 3, app. ¶ 1.28.

[278] As this Article goes to press, the Service and Treasury have provided a similar admonition in the preamble to proposed revisions to the regulations governing transfers of intangibles. See note 293.

specified levels, or particular relative levels, of net income, then the contract itself determines how the parties in fact apportioned the risks associated with all of the parties' functions.

In such a case, the inquiry needed to verify compliance with the arm's length standard would consist of ascertaining that the agreement conforms to the matching principle. If the agreement conforms to the limited-risk model so that one party essentially is ensured a particular level of income, then the inquiry will require verification that the level of income corresponds to market levels, either by reference to comparables or to a safe harbor. If the agreement follows a profit split model, then the inquiry will consist of a determination whether each party's anticipated cost is commensurate with its potential benefits; this is, of course, precisely the inquiry required to verify the bona fides of a cost sharing agreement. In either case, the inquiry required is far less extensive and open-ended than that needed to reconstruct the taxpayer's intentions based on retrospective analysis of all the taxpayer's functions and risks.

Despite these advantages, however, although both the Guidelines and the regulations contain statements to the effect that commercially reasonable intragroup contracts should be respected, neither document encourages companies to use such

contracts as a means of reducing uncertainty in transfer pricing compliance or enforcement. To the contrary, the overall tone of both the regulations and the Guidelines is that of cautioning revenue authorities against being excessively willing to respect the terms of such agreements.

Thus, after devoting a sentence to the notion that intragroup contracts as a general matter should be recognized,[279] the regulations provide a somewhat longer warning that the "actual conduct" of the parties, and the "economic substance" of the transaction, are of paramount importance in an examination.[280] This warning is not incorrect, in that a contract indeed should be respected only to the extent the parties conform to its terms. Nevertheless, the regulations devote more language to the warning against reliance on contracts than to the explanation of their positive roles.

---

[279] Reg. § 1.482-1(d)(3)(ii)(B)(1).

[280] Id. ("In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. . . . If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.").

Moreover, while correct in a logical sense, the language used promotes the fundamentally incorrect, and in the context of transfer pricing administration counterproductive, notion that the economic substance of a transaction is distinguishable from the underlying contractual intent and conduct of the parties.

The warnings in the Guidelines against reliance on intragroup contracts, while extensive, are a bit less sweepingly worded than the corresponding language of the regulations.[281]

---

[281] OECD Guidelines, note 3, app. ¶ 1.29:

=xt

> In dealings between independent enterprises, the divergence of interests between the parties ensures that they will ordinarily seek to hold each other to the terms of the contract, and that contractual terms will be ignored or modified after the fact generally only if it is in the interests of both parties. The same divergence of interests may not exist in the case of associated enterprises, and it is therefore important to examine whether the conduct of the parties conforms to the terms of the contract or whether the parties' conduct indicates that the contractual terms have not been followed or are a sham. In such cases, further analysis is required to determine the true terms of the transaction.

=ft

The Guidelines also say:

=xt

> Associated enterprises are able to make a much greater variety of contracts and arrangements than can unrelated enterprises because the normal conflict of interest which would exist between independent parties is often absent. Associated enterprises may and

Nevertheless, the Guidelines like the regulations fall far short of any positive endorsement of ex ante contracts as a means of reducing uncertainty in transfer pricing compliance and enforcement. Both the Guidelines and the regulations treat the topic of intragroup contracts only briefly;[282] the overall implication is that the topic of intragroup contracts is a relatively minor one, rather than a central conceptual element of the arm's length standard or a compliance tool of substantial practical promise.

The plain fact is, however, that in the absence of such agreements, it can be virtually impossible to resolve transfer pricing disputes in a satisfactory manner. In some unusual situations, the facts might conform so closely to a particular

---

> frequently do conclude arrangements of a specific nature that are not or are very rarely encountered between unrelated parties. This may be done for various economic, legal, or fiscal reasons dependent on the circumstances in a particular case. Moreover, contracts within an MNE could be quite easily altered, suspended, extended, or terminated according to the overall strategies of the MNE as a whole and such alterations may even be made retroactively. In such instances tax administrations would have to determine what is the underlying reality behind a contractual arrangement in applying the arm's length principle.

=ft
Id. at app. ¶ 1.39.

[282] But see discussion of very recent U.S. proposed regulations at note 293.

pattern that, even absent evidence of an explicit ex ante agreement, the parties' intent to arrange their relationship in a particular format reasonably can be inferred. For example, for many years, a parent company might have established its transfer prices with a distribution subsidiary so that the subsidiary enjoyed a relatively stable level of return, regardless of economic conditions. In that circumstance, the facts may support, fairly unambiguously, application of a limited-risk model to the distributor.

In practice, however, in the absence of a written agreement, the facts are rarely sufficiently unambiguous to indicate the particular intent that should be inferred. For example, the income of the distributor may have fluctuated to some limited extent, but neither so little as to support unambiguously an inference of intent to treat the distributor as a limited-risk service provider, nor so much as to support comfortably an inference of an intent to share profits in proportion to cost. In such a situation, the "answer" to the question of the proper allocation of risk is utterly unknowable. At best, the answer is buried among the perhaps conflicting memories of various taxpayer personnel; even if these personnel are physically available, it will be impossible to reconstruct their mindset and divine a clear retrospective picture.

The attempt of the regulations, in particular, to deal with the complexities of this kind of retrospective analysis is particularly noteworthy, in that the regulations deal with the topic in what have become, over time, the notorious "cheese examples."[283] The starting point of the cheese examples is the brief guidance provided by the regulations for use in inferring contractual arrangements in the absence of a written agreement.[284] The examples address this problem in the context

---

[283] Reg. § 1.482-4(f)(3)(iv)(Exs. 2, 3); see, e.g., IRS Working to Address Problems With "Cheese Examples," Official Says, 8 Tax Mgmt. Transfer Pricing Rep. 304 (Aug. 11, 1999); IRS Administration: Business Plan Lists Services Rules Update; Cheese Examples Project Added to Services, 2 Tax Mgmt. Transfer Pricing Rep. 35 (May 16, 2001). As this Article is being prepared for printing, the Service and Treasury have recently proposed revisions to the regulations that would replace the language but not the underlying theory of the cheese examples. See note 293.

[284] Reg. § 1.482-1(d)(3)(ii)(B)(2) provides the following guidance:

=xt

> For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the district director may impute

of determining which party, a non-U.S. manufacturer and supplier or a U.S. distribution subsidiary, is properly to bear the expense of, and reap any rewards from, developing brand value for the manufacturer's product in the United States.

In the first two of the three cheese examples, the parent cheese manufacturer ("Fromage Frere"[285]) and its newly formed

---

a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it. See UCC § 1-205. For example, unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods. See UCC § 2-310.

=ft

[285] Reg. § 1.482-4(f)(3)(iv)(Ex. 2). The choice of cheese as the relevant product, rather than the ever-popular widget, appears to have been inspired by a practitioner's quip. A 1992 article reports that at a 1992 seminar in New York, attorney David Rosenbloom "compared the search for a comparable unrelated transaction to asking 'If you had a brother would he like cheese?'" Tax Foundation Hosts Conference on Transfer Pricing, 92 TNT 113-5, June 1, 1992, available in LEXIS, TNT File. Confirmation of this provenance seems to be provided by the fact that the 1992 precursor to the cheese examples included the

initials “DR,” although they do not remain in the final version. Cf. Prop. Reg. § 1.482-2(d)(8)(iv)(Ex. 4), 58 Fed. Reg. 5263-02 (Jan. 21, 1993).

The “cheese” language appears to have originated from the following lines from the comedy that played at Ford’s theater the night that President Lincoln was assassinated:

> Dun: A cow! Well, that accounts for the milk and butter; but I don’t see the eggs; cows don’t give eggs; then there’s the cheese—do you like cheese?
>
> Geo: No, my lord.
>
> Dun: Does your brother like cheese?
>
> Geo: I have no brother. I’m so delicate.
>
> Dun: She’s so delicate, she hasn’t got a brother. Well, if you had a brother do you think he’d like cheese?

Tom Taylor, Our American Cousin (1915), http://www.gutenberg.net/etext02/ouamc11.txt. The authors are grateful to Richard Gordon for pointing out the history of the cheese language; one of the authors of the current article has reported the text above in a paper discussing recent proposed regulations. Michael C. Durst, The Proposed Transfer Pricing Regulations on Intangibles: Cheese Brother, Where Art Thou? 3-4 n.6 (paper prepared for

U.S. distribution subsidiary have not made explicit contractual arrangements concerning their intended sharing of the risks and rewards of brand development; the parent, however, retains legal ownership of the U.S. trademark rights.[286] The examples explain

---

George Washington Univ/Int'l Tax Conf. Dec. 2003, on file with the Tax Law Review).

[286] The examples are as follow:

=xt

> *Example 2*. FP, a foreign producer of cheese, markets the cheese in countries other than the United States under the tradename Fromage Frere. FP owns all the worldwide rights to this name. The name is widely known and is valuable outside the United States but is not known within the United States. In 1995, FP decides to enter the United States market and incorporates U.S. subsidiary, USSub, to be its U.S. distributor and to supervise the advertising and other marketing efforts that will be required to develop the name Fromage Frere in the United States. USSub incurs expenses that are not reimbursed by FP for developing the U.S. market for Fromage Frere. These expenses are comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry when introducing a product in the U.S. market under a brand name owned by a foreign manufacturer. Since USSub would have been expected to incur these expenses if it were unrelated to FP, no allocation to USSub is made with respect to the market development activities performed by USSub.
>
> *Example 3*. The facts are the same as in *Example 2*, except that the expenses incurred by USSub are significantly larger than the expenses incurred by independent distributors under similar circumstances. FP does not reimburse USSub for its expenses. The district director concludes based on this evidence that an unrelated party dealing at arms length under similar circumstances would not have engaged in the

that the determination of whether the parent or the subsidiary is to be viewed as the party bearing the risks, and therefore as the party entitled to any rewards, from the brand development should be based on whether the distributor bore a level of expenses that was "comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry when introducing a product in the U.S. market under a brand name owned by a foreign manufacturer."[287]

In the first example, the distributor's expenses are found not to have been above those incurred by comparable U.S. cheese distributors; accordingly, the U.S. subsidiary need receive no compensation from the parent for incurring the expenses, and presumably the foreign parent will enjoy any special benefits arising from the successful development of U.S. brand value. In the second cheese example, the marketing expenses "are significantly larger than the expenses incurred by independent

---

> same level of activity relating to the development of FP's marketing intangibles. The expenditures in excess of the level incurred by the independent distributors therefore are considered to be a service provided to FP that adds to the value of FP's trademark for Fromage Frere. Accordingly, the district director makes an allocation under section 482 for the fair market value of the services that USSub is considered to have performed for FP.

=ft
Reg. § 1.482-4(f)(3)(iv).

[287] Reg. § 1.482-4(f)(3)(iv)(Ex. 2).

distributors under similar circumstances."[288] Accordingly, the subsidiary is viewed as performing a service for the parent, for which the subsidiary must receive compensation on a year-by-year basis.

The key point is that nowhere do the regulations indicate how, as a practical matter, either the taxpayer or the Service is to determine whether any particular level of expenditures was "comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry when introducing a product in the U.S. market under a brand name owned by a foreign manufacturer." In all likelihood, there will not be even one independent U.S. distributor of foreign cheese for which financial information is publicly available, let alone a sufficient number of such distributors to permit a valid statistical sample. Moreover, even if such distributors exist, it will be virtually impossible to compare their "functions," in any degree of detail, with those of the Fromage subsidiary in the United States. In actual practice, an examination involving an issue of this kind is likely to involve an extended dispute over fragmentary data drawn from a list of, say, distributors of beverages or of wide ranges of unbranded groceries, or perhaps of supermarket or convenience store chains; the data are

---

[288] Reg. § 1.482-4(f)(3)(iv)(Ex. 3).

unlikely to offer a resolution that is satisfactory to both parties.

In this light, the third and final cheese example[289] is particularly noteworthy. In that example, a written contract indicates the parties' intent that the U.S. subsidiary is to bear the costs and enjoy any rewards from local brand development.[290] The dispute is thus resolved in large measure before it begins.

Recent Field Service Advice (FSA)[291] shows the reality of disputes over issues such as that posed in the cheese examples, in the absence of a clear indication of the taxpayer's contractual intent. The FSA deals with a distribution situation

---

[289] Reg. § 1.482-4(f)(3)(iv)(Ex. 4).

[290] The example says:

=xt

> *Example 4*. The facts are the same as in *Example 3*, except that FP and USSub conclude a long term agreement under which USSub receives the exclusive right to distribute cheese in the United States under FP's trademark. USSub purchases cheese from FP at an arm's length price. Since USSub is the owner of the trademark under paragraph (f)(3)(ii)(A) of this section, and its conduct is consistent with that status, its activities related to the development of the trademark are not considered to be a service performed for the benefit of FP, and no allocation is made with respect to such activities.

=ft

[291] FSA 200019026 (Feb. 11, 2000).

identical in structure to that of the cheese examples; the parent and subsidiary had not memorialized their intent regarding brand development costs in an ex ante agreement. The FSA noted, with perhaps a trace of a scolding tone, the taxpayer's failure to enter into such an agreement, and then concluded with remarkable frankness that in the absence of such an agreement, the Service basically was free to interpret the facts in any manner it desired.[292] It is likely in such a

---

292

=xt

> [I]n general, in the section 482 context as elsewhere, the Service will evaluate transactions as the taxpayer has structured them, unless such structure lacks economic substance. Treas. Reg. § 1.482-1(f)(2)(ii). In that regard, the Service will respect the actual written contractual terms adopted between controlled taxpayers for their transactions, again provided such terms are consistent with the economic substance. Treas. Reg. § 1.482-1(d)(3)(ii)(B). Where, however, the controlled parties have not spelled out the terms of their transactions, or have done so only ambiguously or in a manner inconsistent with the economic substance, then the Service has the authority to impute a transaction that is consistent with the economic substance. Id. This case presents the more difficult situation for the Service, in that the controlled parties did not spell out their transactions, or did so only in an ambiguous or inconsistent manner. In such a case the Service may be faced with a choice of potential alternative constructions of the economic substance that are more or less consistent with the facts of the controlled taxpayers' actual course of conduct and their respective legal rights. The Service's task in such a case is to try to ascertain which alternative construction of the substance better reflects these facts. Where the available facts are equally

circumstance that the Service will choose to apply an interpretation not to the taxpayer's liking; a dispute will ensue, in which the parties are likely to have available few if any objective reference points to aid in resolution. The absence of an ex ante agreement leaves the tax system, quite literally, clueless.[293]

> consistent with one or more alternative constructions (which Examination may determine are the circumstances of this case), then the taxpayer has effectively left the choice among the potential constructions to the Service's judgement.

=ft
Id.

[293] In September 2003, the Service and Treasury proposed revisions to the regulations that would replace the cheese examples with new examples (notably, not involving foodstuffs). The proposed new examples would not focus particularly on the notion of "excess" advertising expenses, but nevertheless would continue to envision highly detailed factual inquiries, based on the licensor and licensee's relative contribution to the development of marketing intangibles, in order to determine the manner in which the licensor and licensee should share profits attributable to the intangibles. Prop. Reg. § 1.482-4(f)(3)(ii), (4)(ii), 68 Fed. Reg. 53447, 53462-63 (Sept. 10, 2003). Perhaps, most importantly, the preamble to the proposed regulations acknowledges the great difficulties likely to be

In sum, the question is not whether transfer pricing enforcement must refer to contractual agreements made among related parties. The question is whether the parties in any given instance are to manifest that intent themselves, or whether instead the government, should it choose to examine the parties' transfer pricing, is to infer a contractual agreement retrospectively based on whatever evidence is (or is not) available. Taxpayers thus will need to establish the habit of entering into such agreements, and governments should encourage them to do so if the transfer pricing system is to have a reasonable prospect of operating satisfactorily on a long-term basis.

Ex ante agreements cannot solve all of the difficult problems of transfer pricing compliance and enforcement. In any given instance, the question will remain (1) whether the agreement was as an initial matter commercially reasonable (for example, consistent with the matching principle described

---

posed by such factual inquiries, and the preamble encourages taxpayers to enter into ex ante contractual arrangements in order to limit the need for such inquiries. Preamble to Prop. Reg. §§ 1.482-4, -9, 68 Fed. Reg. 53447, 53458 (Sept. 10, 2003). For an initial reaction to this element of the proposed regulations, see Durst, note 285.

above), as well as (2) whether the parties in fact complied with the agreement as written. Moreover, even the most patently reasonable contract, to which the parties have plainly and scrupulously adhered, cannot eliminate the "buy-in" issues that can arise when a multinational group changes the contractual structure under which it conducts intragroup business.[294] Thus, greater use of ex ante agreements can provide only partial relief from the difficulties of transfer pricing compliance and enforcement. More widespread use of such contracts nevertheless could make a significant contribution to the reduction of compliance costs and uncertainties.

=S3 3. A Particular Kind of Ex Ante Agreement: APAs@

The debates of the late 1980's and early 1990's did produce rules, in the United States and elsewhere, that provide for one particular type of ex ante transfer pricing agreement, namely "advance pricing agreements" (as they are called under U.S. practice), and "advance pricing arrangements" as they are called under the OECD Guidelines.[295] The OECD Guidelines express

---

[294] See notes 238-239 **[x]** and accompanying text.

[295] Diane Ring, On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation, 21 Mich. J. Int'l L. 143 (2000),

qualified approval of APA programs,[296] and over time a number of countries have developed APA programs.[297] APAs can be either "unilateral" (for example, between the taxpayer and only one government) or, preferably from the standpoint of the OECD and all governments that have adopted APA programs,[298] "bilateral" or "multilateral," in that they involve agreement among the taxpayer and the competent authorities, under applicable tax treaties, of at least two governments with an interest in the

---

provides a comprehensive analysis of the APA program and its implications in the broader field of administrative law.

[296] OECD Guidelines, note 3, app. ¶¶ 4.124-4.126, updated by Annex to OECD Guidelines, Guidelines for Conducting Advance Pricing Arrangements Under the Mutual Agreement Procedure (MAP APAs), Oct. 1999, reprinted in Materials on International & EC Tax Law 698 (Kees van Raad ed., 2d ed. 2002).

[297] A 2001 survey describes activities in 18 different countries, including the United States. 2001 Global Review of Advance Pricing Agreement Programs, 10 Tax Mgmt. Transfer Pricing Rep. (Sept. 19, 2001, Supp.).

[298] See Rev. Proc. 96-53, § 7.07, 1996-2 C.B. 375, 382 (expressing preference for bilateral or multilateral APAs); OECD Guidelines, note 3, app. ¶ 4.163 ("Wherever possible, an APA should be concluded on a bilateral or multilateral basis. . .").

tax results of the intragroup transactions that are the subject of the APA.

APAs take full advantage of the principle that ex ante manifestations of taxpayer intent can avoid the need for costly ex post controversies. Psychologically as well, agreement in financial disputes often seems easier before rather than after the fact, since after-the-fact resolution often requires one or both of the parties to consider relinquishing benefits that, albeit perhaps temporarily, the party already possesses. In the authors' experience both of these kinds of benefits can be obtained in some instances from the APA process.

Nevertheless, it also must be accepted that the APA process, or any other procedural innovation, can have only incremental effect on the performance of a transfer pricing system. Such a program can cover only a relatively small proportion of the transactions even of large taxpayers. Further, a program of advance resolution must apply the same substantive standards as would apply in after-the-fact resolution. If these standards do not easily apply in one setting, they cannot easily apply in another.

Thus, for example, if the identification of appropriate comparables is troublesome in examinations, it also will be troublesome in advance resolutions. Indeed, practitioners often complain of an adversarial atmosphere in APA proceedings, just

as they do in examinations.[299] As an empirical matter, taxpayer interest in APAs in the United States appears to be holding

---

[299] Thus, for example, a 1997 article notes practitioner complaints of the adversarial nature of the process (Practitioners Say Field Is Slowing Process, Refusing to Agree to Some Rollbacks of APAs, Tax Mgmt. Transfer Pricing Rep. (July 30, 1997)). **=fb [check] =fn** More recently, tension between the jurisdictions of field and national office IRS personnel seems to have limited attempts to resolve difficult buy-in issues through the APA Program. See Advance Pricing Agreements: Attorney Says Program Has No Jurisdiction Over Buy-In Issues When "Touched" by Exam, 10 Tax Mgmt. Transfer Pricing Rep. 983 (Apr. 17, 2002).

As this Article goes to press, however, the Senate Finance Committee, citing what it understands to have been rapid recent growth in the APA Program, and expressing as well a desire to ensure that APAs are not excessively favorable to taxpayers, has initiated a review of the program's operations. See, e.g., Molly Moses, Senators to Review Whether APAs Used as Tax Shelters, Tax Mgt. Transfer Pricing Rep. 711 (Jan. 7, 2004); Finance Committee Staffer Says Review of Program Not Meant to Impede Progress, Tax Mgt. Transfer Pricing Rep. 824 (Feb. 4, 2004). **=fb [check both] =fn**

about steady, not growing.[300] In sum, the APA process is significant, but if the substantive rules governing the transfer pricing system are flawed, greater reliance on APAs is not likely to cure resulting difficulties.

=S2 C. Absence of Safe Harbors@

Among the most interesting aspects of the U.S. regulations and the OECD Guidelines is their treatment of the possible allowance of safe harbors for use by taxpayers who do not wish to subject themselves to the uncertainties of after-the-fact transfer pricing enforcement. Safe harbors are, of course, common in the tax law as a way of limiting dispute over difficult factual matters; notable examples include pre-

[300] The Service reported receiving 69 APA requests in 1999, 91 in 2000, and 77 in 2001. Each year, the requests received probably include an increasing number of requests for renewal of prior APAs. Thus, the number of new requests in 2001 probably was about the same as the number filed in 1999. See Announcement 2000-35, 2000-1 C.B. 922, 925 (First Annual APA Report); Announcement 2001-32, 2001-1 C.B. 1113, 1117 (Second Annual APA Report); Announcement 2002-40, 2002-1 C.B. 747, 752 (Third Annual APA Report).

determined depreciation lives,[301] guidelines for distinguishing between U.S. and foreign source income or expenses in specified situations,[302] and guidelines for distinguishing between sales and leases of tangible property.[303] In the area of transfer pricing, the U.S. regulations have long provided safe harbor interest rates for determining arm's length compensation in dollar-denominated loans.[304] In addition, albeit to a very limited extent, some countries provide safe harbor markups on cost to be used in the pricing of services between members of commonly controlled groups.[305]

---

[301] See IRC § 168(e).

[302] See, e.g., Reg. § 1.861-17 (allocation of research and development expense); § 1.863-3(b)(1) (allocation of inventory sales using the "50/50 method").

[303] See Rev. Proc. 2001-28, 2001-1 C.B. 1156.

[304] Reg. § 1.482-2(a)(2).

[305] Cf., e.g., Mexico's Temporary Maquiladora Rules for 2002, 11 Tax Mgmt. Transfer Pricing Rep. 147 (May 29, 2002) (describing Mexican safe harbor returns for use in limited circumstances); ATO Issues Final Ruling on Services Incorporating Safe Harbor on Cost Markups, 7 Tax Mgmt. Transfer Pricing Rep. 732 (Jan. 27, 1999) (describing limited safe harbor available in Australia).

Facially, the transfer pricing debates of the late 1980's and early 1990's would appear to have provided fertile ground for the proposal and adoption of transfer pricing safe harbors. The debates began, after all, with observations by the Congress and Treasury that the benchmarks traditionally relied upon by transfer pricing rules were not likely to provide clear guidance in many circumstances. One might have expected taxpayer interests and governments to work in concert to devise safe harbors that would be designed to provide greater certainty, and to reduce compliance and enforcement costs, to the benefit of all parties.

Indeed, the White Paper, the proposed and temporary regulations in the United States, and the OECD Guidelines[306] all contain discussion of proposals for safe harbors. Some of these proposals would have called for profits to be split between related parties based on simple comparisons of the levels of cost historically borne in different jurisdictions. Such proposals, by not treating separately costs that were borne in ultimately successful efforts to develop high-value intangibles,

---

[306] White Paper, note 68, at 481-82; Prop. Reg. § 1.482-2(d)(4), 57 Fed. Reg. 27716-02 (June 22, 1992); Temp. Reg. § 1.482-1T, 58 Fed. Reg. 28921-01 (May 18, 1993); OECD Guidelines, note 3, app. ¶ 4.122.

would seem to have lent themselves readily to the kind of intangibles migration with which Congress was concerned in the 1986 Act and on which Treasury focused in 1988[307] (and which, as of this writing, Treasury once again has identified as a perceived compliance problem;[308] it is not surprising that such proposals received little serious consideration.

Other proposals, however, were more intriguing. The general tenor of such proposals was that taxpayers might elect to apply benchmarks to particular activities based on arm's length ranges published in advance by governmental authorities, rather than relying on a comparables search and functional analysis to establish those ranges. Indeed, Treasury included a proposal to establish such a safe harbor in regulations proposed in 1993,[309] although it was removed in the version of the regulations finally promulgated in 1994.[310] Unlike expense-based, profit split safe harbors, there appears to be no fundamental theoretical objection to applying such safe harbor rates to activities subject to limited risk. As a conceptual

---

[307] See notes 83-93 and accompanying text.

[308] See note 314 and accompanying text.

[309] Temp. Reg. § 1.482-1T(f), 58 Fed. Reg. 28921-01 (May 18, 1993).

[310] Reg. § 1.482-1(h)(1).

matter, they would simply envision the government performing, albeit at least theoretically in a less precise and individually tailored manner, a benchmarking exercise that taxpayers otherwise are expected to perform themselves.

Part of the reason for rejection may be that the heated environment of the late 1980's and early 1990's did not allow for the kind of detailed cooperative work among competing interest groups that probably is necessary for the construction of workable safe harbors, which even in their simplest forms require difficult technical details to be addressed. For example, the 1993 U.S. proposal for a safe harbor for the limited-risk paradigm seems to have envisioned a fairly crude measure that taxpayers would be permitted to apply to a wide range of factual situations, some of which might conform to the assumptions underlying the safe harbor, and others might not. To be useful, a safe harbor needs to say a bit more about the factual predicate on which it is based. A safe harbor might specify, for example, that it will apply only to taxpayers that have bound themselves contractually to perform manufacturing services for related parties over a specified minimum period of time in return for pre-arranged and level compensation, using intangibles that were not developed at the expense of the manufacturing entity itself.

Given the nature of the safe harbors considered in the late 1980's and early 1990's, it is not surprising that they were rejected apparently based at least in large part on the fear that taxpayers would apply them in a one-sided manner—that taxpayers would apply them only when, say, the safe harbor level of profitability offered was less than the "correct" arm's length level.[311] Such a danger indeed must have appeared overwhelming if it was envisioned that safe harbors would simply specify income levels without specifying corresponding factual predicates.

If, however, a safe harbor specifies in addition the factual predicate to which the taxpayer must conform in order to avail itself of the safe harbor, then it would appear to offer no more scope for gaming, and possibly considerably less, than the current system. Whether or not a taxpayer is operating under a safe harbor, in order to verify compliance the government must determine (1) the terms of the controlled transactions under examination, including the division of functions and risks between the parties, and (2) that the pricing established between the parties is reasonable in view of the division of functions and risks. The contribution of a safe harbor is that it determines in advance that, provided the

[311] See OECD Guidelines, note 3, app. ¶¶ 4.116-4.119.

parties have agreed to conform, and in fact do conform, to a specified division of functions and risks, a particular pricing regime will be accepted as reasonable. Verifying the arrangement thus reduces to ascertaining that the taxpayer in fact conformed to the previously specified division of functions and risks, and that the taxpayer in fact priced in the manner specified under the safe harbor. Eliminated are the nearly (if not entirely) impossible tasks of (1) identifying, in the absence of guidance from a pre-specified template, how the parties in fact divided their functions and risks, and (2) deciding on a case-by-case basis the kind of pricing arrangement that is appropriate to the particular division of functions and risks, even if that division can be identified confidently.

In sum, the rejection of safe harbors in the recently concluded transfer pricing debates seems to have derived at least in large part from technical deficiencies in the relatively simple kinds of safe harbors that were considered; nevertheless, political factors may have been in play as well. To the extent that some participants in the transfer pricing debates of the late 1980's and early 1990's sought to protect existing patterns of ex post enforcement of the arm's length standard based on whatever comparables might be found, the use of safe harbors that would have enabled taxpayers to determine their compliance on an ex ante basis may have been deemed

inconsistent with that goal. Indeed the OECD Guidelines display a hostility to safe harbors that seems to transcend merely practical concerns.[312] It is, however, worth considering whether, in light of practical experience with the ex post focus of the U.S. regulations and OECD Guidelines over the past several years, as contrasted with the ex ante compliance burden increasingly being imposed on taxpayers, the perceptions of at least some participants in the debate may have shifted to an extent that would render safe harbors more palatable.

---

[312] See, e.g., OECD Guidelines, note 3, app. ¶ 4.122:

=xt

> Under the normal administration of tax laws, certainty cannot be guaranteed for the taxpayer, because administrations must retain the ability to review any aspect of a taxpayer's income tax assessment, including the area of transfer pricing. Fundamentally, the introduction of a safe harbour means that the tax administration surrenders a portion of its discretionary power in favour of automatic rules. Tax administrations may not be prepared to go that far, and may consider it essential to retain the ability to verify the accuracy of a taxpayer's self-assessed tax liability and its basis. Compliance simplicity may also often be subordinated to other tax policy objectives such as reasonable and adequate documentation and reporting and the prevention of tax avoidance.

=ft

=S1 V. Proposals for Improvement@

=S2 A. Half a Loaf vs. Pie in the Sky: The Joys of Incremental Improvement[313]@

The current state of the § 482 regulations and the OECD Guidelines reflects a significant amount of negotiation and compromise. Those compromises in the ensuing years have been implemented through an increasingly standardized set of practices that present significant concerns of their own. Whether we view the current problems as having arisen from flaws in the principles adopted by the documents, or from the difficulty of transforming sound theories into real-world practice, the bottom line is that the compromises reached in the guidance processes have resulted in an unstable state of practice today.

---

[313] The late Senator Paul Douglas of Illinois (who, it should be mentioned in the current context, was a noted economist as well as a Senator) gave a speech near the end of his public career in which he apparently said: "When I was young I wanted to save the world. . . In my middle years I would have been content to save my country. Now I just want to save the [Indiana] Dunes." William H. Freivogel, Standards: Ex-Senator's Birthday Puts Focus on Ethics, St. Louis Post-Dispatch, Mar. 26, 1992, at 1.

On the other hand, one important lesson to be drawn from our historical and conceptual review of today's transfer pricing system is that some of the primary factors affecting the system's development have arisen from political constraints, rather than limitations on the supply of analytical insight. In particular, the debates of the late 1980's and early 1990's seem to have consisted to a great extent of a tug-of-war, between Treasury on one side and most foreign governments and multinational businesses on the other, over the essentially political question of whether additional resources should be devoted to transfer pricing enforcement.

A truly fundamental revision of transfer pricing rules would require a substantial shift from the political alignments related to transfer pricing of the mid-1990's. Conceivably, external events such as the emergence in one or more countries of a perceived transfer pricing compliance problem,[314] or perhaps

---

[314] One recent commentary suggests that such concerns could lead to a re-examination of current transfer pricing rules:

=xt

> After many fits and starts in recent years over the substantive rules, as well as the procedures for determining such prices and the penalties for making "mistakes," the international tax community, including most first-world governments, the OECD, and many businesses, now seem to be embracing the fairy tale that the transfer-pricing problem is pretty much under control. This, however, is no doubt only a temporary

lull until the next round of transfer pricing abuses captures the attention of Congress or other policymakers.

=ft

Michael J. Graetz, Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies, The David R. Tillinghast Lecture, NYU School of Law (Oct. 26, 2000), in 54 Tax L. Rev. 261, 318 (2001).

Indeed, recent compliance-related events do appear to be eliciting a Treasury re-examination of transfer pricing issues. See Acting Assistant Secretary Pamela Olson's Testimony at Ways and Means Hearing on Corporate Inversions, 2002 TNT 110-31, June 6, 2002, available in LEXIS, TNT File:

=xt

> Treasury and the IRS will undertake an initiative to review current practices related to the examination of transfer pricing issues and the imposition of transfer pricing penalties, with a particular emphasis on transactions in which intangibles are transferred. The volume and complexity of cross-border related party transactions have grown significantly in recent years, and a number of U.S. trading partners have undertaken broad compliance initiatives relative to transfer pricing. The purposes of this comprehensive review will include ensuring that contemporaneous documentation from taxpayers is utilized effectively by the IRS and that transfer pricing penalties are imposed where warranted on a fair and consistent basis. This focused review also will help identify potential improvements to existing rules, including the provisions regarding penalties, reporting, and documentation, that would enhance transfer pricing compliance.

an unexpected growth in momentum of discussions currently underway in the European Community regarding the possible adoption of a Europe-wide formulary approach,[315] could lead to sweeping changes in transfer pricing rules. Should political demand for fundamental changes arise, we hope that the analysis provided in this Article will prove helpful in designing an effective system.

Even if political demand for fundamental changes to the transfer pricing system does not arise, however, it nevertheless

---

=ft

As the current article is prepared for press, the Service is promising proposed revisions to the regulations governing cost-sharing "buy-ins" by June 30, 2004. See Cost Sharing Rewrite May Contain List of Specified Methods, IRS Official Says, Tax Mgt. Transfer Pricing Rep., Feb. 4, 2004, at 823. **[check]** See also Glen R. Simpson, A New Twist in Tax Avoidance: Firms Send Best Ideas Abroad, Wall St. J., June 24, 2002, at A1.

[315] See, e.g., Europe: EU Officials Continue to Show Interest in Formula-Based Alternative to Arm's Length, 10 Tax Mgmt. Transfer Pricing Rep. 519 (Nov. 14, 2001); European Union: EC Staffer Says Formulary Apportionment Unlikely to Gain Ground Despite EU Interest, 10 Tax Mgmt. Transfer Pricing Rep. 855 (Feb. 20, 2002).

seems likely that perceptions have changed sufficiently since the mid-1990's to make feasible some badly needed incremental reforms.[316] Enough time has now passed to demonstrate that the changes of the mid-1990's have not adequately reduced the frictions of the enforcement process. Similarly, in our view, substantial dissatisfaction is arising among many companies over the costs of transfer pricing documentation that does not seem to achieve the overall reduction in compliance burdens that documentation was supposed to provide.

The remainder of this Article accordingly suggests relatively incremental changes, some of which would not require formal amendment to currently applicable rules, and most of which are implicit in the substantive comments set forth above. None of the proposals would require removal of any substantial element of the current structure, which would remain available in its entirety to those companies that have relied upon it and

[316] A recent report describes observations by John Neighbour, an OECD official, to the effect that some of "the 'political heat has gone out'" of pricing controversies, and that the passage of seven years should enable parties to "'look a little more coldly' at them." See OECD to Conduct Peer Review of Mexico's Transfer Pricing Policies, Rules, 10 Tax Mgmt. Transfer Pricing Rep. 993 (Apr. 17, 2002).

continue to wish to do so. We recommend the addition or refinement of various mechanisms to permit those companies that seek it to achieve greater certainty, and lower compliance costs, than generally are available under the existing system.

Even these incremental measures may encounter political opposition, if only because they suggest models that in the future might be applied toward more pervasive reforms. Nevertheless, the incremental approaches suggested here are essentially limited, and we hope that they can be fit into the current system without threatening the overall compromises reached in the mid-1990's.

=S2 C. Specific Proposals@

=S3 1. Encourage the Use of Ex Ante Contracts@

Perhaps the most important change that could be made would require no amendments of existing regulations and guidelines—namely, greater use by taxpayers of ex ante written agreements to provide clear articulation of the manner in which the companies conform to the arm's length standard. Both the U.S. regulations and OECD Guidelines already provide rules allowing for such use, notwithstanding that the rules are to some extent buried among the much more voluminous portions of the regulations and guidelines articulating a retrospective approach

to enforcement.[317] Nevertheless, despite the availability of ex ante contracts even without further governmental action, governments could facilitate the use of commercially reasonable ex ante contracts through several measures.

Governments, for example, should incorporate into their rules more examples in which taxpayers successfully use ex ante agreements to facilitate compliance and enforcement.[318] In addition, governments should address and remedy any technical barriers under local laws to the use of ex ante contracts. Particularly in the United States, revisions to the regulations might provide that, if the taxpayer elects to employ a profit split method that is described in a contract entered into prior to the taxable year, and the terms of the contract are commercially reasonable, the profit split method will qualify as a specified method for purposes of the penalty provisions of § 6662. In addition, following the example of the current treatment of cost sharing in the U.S. regulations and OECD Guidelines,[319] governments should clarify that the entry into a

---

[317] See notes 273-300 **[x]** and accompanying text. See also note 293 (describing language in preamble to recently proposed U.S. regulations encouraging taxpayer use of ex ante contracts).

[318] Cf. Durst, note 285.

[319] See OECD Guidelines, note 3, app. ¶¶ 8.1-8.43.

contract among commonly controlled entities designed to memorialize their use of a particular transfer pricing method, including a profit split method, will not create a partnership among the affiliates or otherwise result in any affiliate located outside of a particular jurisdiction being treated as engaged in a trade or business in the jurisdiction, provided that the entity does not have authority to act in the name of any of the other affiliates, the affiliates hold themselves out to the public as separate legal entities, and the activities of the participants to the contract do not otherwise support the conclusion that an entity other than the locally incorporated entity is engaged in a trade or business in the jurisdiction.

=S3 2. Clarify the Limits of Statistical Methods@

An additional reform pertains primarily but not exclusively to the United States. The government should revise the regulations to limit the role ascribed to statistical methods, in a manner that is consistent with sound statistical techniques. Under current practice such techniques as the use of an interquartile range may provide a thin veneer of quantitative rigor, but in fact serve only to increase transaction costs and magnify disputes. The extensive but flawed technical superstructure that has been built on the regulations in current practice does not serve any useful

function. At most, the superstructure creates in the casual observer the illusion that a scientific approach to the transfer pricing issue has been put in place, but that image is so fragile that it is likely to be of only temporary effect. The structure already has attracted derision and is likely to attract more.

In particular, the regulations should disfavor the use of statistical methods such as the interquartile range in the case of small samples, and instead should specify that taxpayers employing methods based on data from comparables must establish their prices so as to achieve results that do not vary substantially from the results indicated by the best data reasonably available from uncontrolled transactions and uncontrolled entities. The regulations also might suggest a presumptive standard of acceptable deviation by providing, for example, that a deviation from the indicated pricing level involving an increase or reduction, by more than some reasonably specified tolerance level such as 15 or 20%, in the net operating income derived from an activity normally would be considered "substantial."

Such an approach might seem less precise than the current method incorporating the interquartile range, but in fact the ranges derived under the suggested method generally should be much narrower than the interquartile ranges typically used in

practice today. Moreover, the suggested approach frankly acknowledges the subjectivity of determining arm's length prices by reference to uncontrolled comparables. Thus, the approach would permit the resolution of disputes through straightforward reconciliation of conflicting judgments, rather than requiring disputes to be cast in terms of ostensible challenges to the scientific merit of analyses provided by the competing sides.[320]

---

[320] It might be feared that by recommending modification of those statistical approaches in the regulations that lead to very wide ranges, our analysis might lead to an undesirable narrowing of acceptable arm's length ranges, thereby encouraging excessive adjustments on the part of tax authorities. Our view, however, is that the ranges reached under the current statistical approach are so wide as to raise a very high likelihood of challenge in examination to the taxpayer's choice of comparables. Thus, although the idea of the arm's length range undoubtedly was intended to discourage de minimis adjustments, by affording taxpayers what amounts to a reasonable safe harbor, the effect of the current rules is to deny taxpayers the practical protections that the range is supposed to provide. Thus, we believe that replacing what we perceive to be a flawed statistical approach will lead to greater, not lesser, protections for taxpayers.

Although the most immediately intended benefit of the suggested approach is the removal from the U.S. regulations of the unjustifiable expectation that statistical analysis can satisfactorily identify an arm’s length range where only small samples are available, the suggested approach also would seem useful to countries that follow the OECD Guidelines. The suggested approach to the identification of a range already is similar to that of the OECD, in that it does not hide the fact that an identification of the range must rest heavily on subjective judgment. The suggested approach, however, would supply a bit more structure than the Guidelines, in that it would provide some level of definition to the width of the range by reference to, for example, a 15 or 20% presumption or some similar presumptive tolerance level.

The suggested approach therefore could provide a useful middle ground that would be acceptable as a basis of documentation practice both within and outside the United States. Such an approach would fall far short of removing all of the uncertainties inherent in comparables-based analysis, but it could provide a more satisfactory format for comparables-based documentation for use in many different jurisdictions.

=S3 3. Provide Limited Safe Harbors for Use With Income-Based Methods@

The government in the United States and elsewhere should specify safe harbor ranges of income for use by taxpayers that have entered into ex ante contracts to perform limited-risk manufacturing or distribution functions in return for compensation that will not vary substantially on an annual basis. Such safe harbors should specify that they will not prevent government challenge of the taxpayer's treatment of any tax consequences arising from the original establishment of such an arrangement, or the termination or modification of such an arrangement, thus clarifying that the safe harbor is not intended to extend to buy-in issues.

A safe harbor of this kind should not increase the likelihood of competent authority disputes. The wide latitude that current conceptions of the interquartile range allow to taxpayers and governments alike raises a greater likelihood of intergovernmental dispute than would presumably narrower safe harbor ranges such as those suggested here. Moreover, by its dependence on the taxpayer having entered into a clear intragroup agreement, the safe harbor would seem to reduce the scope for factual disagreement in the context of competent authority negotiations.

Even the limited kind of safe harbor envisioned here may elicit political opposition. Some government officials may perceive a potential for such a safe harbor to reduce their current scope of discretion. Some may perceive in the safe harbor an undesirable precedent for what over time might become an excessively mechanical transfer pricing system. Such arguments, however, should not outweigh the advantages that a safe harbor could provide in reducing transaction costs and uncertainty in a range of frequently recurring situations.

=S3 4. Begin Consideration of Safe Harbor Lives for Expenditures Intended to Generate Intangibles@

The outer frontier of the changes suggested in this Article is the possible articulation by governments of safe harbor useful lives for different kinds of intangibles-creating expenditures for use in determining expense-based profit splits. For example, a country's rules might provide that an affiliate that bore all of a group's research and development expenditures within a given category for, say, the last three, five, or ten years, depending on the class of intangible, therefore would be entitled to the income derived from that class of intangibles. Where such expenditures had been shared over that period among different affiliates, their respective shares would be built

into the profit split. Similar approaches could apply to marketing expenditures.

While initially it might seem that the variety of intangibles and intangibles—creating expenditures in the marketplace would render the compilation of a table of safe harbor lives impractical, in fact such safe harbors are commonplace in areas of the tax law other than transfer pricing.[321] Moreover, currently, in the absence of safe harbors, companies are put in the position of determining their own useful lives for transfer pricing purposes, and the result has been an extraordinarily uncertain environment giving rise to a high level of controversy, particularly over the buy-ins used when initiating cost-sharing arrangements.

In the long term, the transfer pricing system almost certainly will need to provide safe-harbor lives for intangibles-generating expenditures. The alternative is for the system ultimately to dissolve in endless controversy over buy-ins, not only in the area of explicitly stated cost-sharing agreements, but in countless other instances in which changes in taxpayers' arrangements raise the possibility that intangibles have been transferred.

---

[321] See notes 301-304 **[x]** and accompanying text.

We recognize that there are significant barriers to any immediate implementation of an approach based on safe harbor lives for intangibles-generating expenditures. Current controversies over buy-ins, particularly in the United States, are likely to render dispassionate consideration of such safe harbors difficult. In addition, opposition might arise on the ground that the safe harbor lives, and the kinds of profit splits that they would facilitate, too closely evoke a formulary approach, notwithstanding that in fact the safe harbors and related profit splits bear little resemblance to the generic formulas used by the states, which ignore intangibles entirely. Nevertheless, we believe that the idea is likely to be important to the future of transfer pricing under the arm's length standard. Accordingly, while implementation may lie beyond the immediately foreseeable future, governments and taxpayer and practitioner groups should begin the empirical research and analytical work on which such a system could be based.

=S1 VI. A Mildly Hopeful Conclusion@

The transfer pricing system in place today does not conform to any theoretically defined model. The system instead is a hodgepodge of sometimes conflicting and sometimes patently unworkable elements, the adoption of which have resulted far

more from political compromise than from conscious design pursuant to an internally consistent conceptual system.

In these respects, of course, the transfer pricing system does not differ significantly from any other body of tax laws, and particularly any other element of the corporate income tax laws. The heated nature of recent transfer pricing debates, however, arguably has imparted to the transfer pricing field an even greater attention to symbolism than that found in most other areas of taxation. Phrases such as "arm's length," "formulary," "net-income based," and "safe harbor" seem to have taken on meanings well beyond their conceptual content. This emphasis on symbolism sometimes seems to inhibit what in actuality may be relatively modest reforms.

We hope that this discussion achieves a useful balance between criticism of past and existing patterns of rulemaking in the area of transfer pricing, and practicality in identifying potential areas of improvement that can be implemented in the current political context. The incremental approach suggested here cannot hope to provide the last word to the transfer pricing debate; a lasting practical solution that both satisfies governments that they are receiving their fair shares of cross-border income, and that does not impose excessive compliance burdens and uncertainties on taxpayers, remains nowhere in sight. Nevertheless, we try to suggest measures that can permit

an arm’s length system to function at an appreciably lower level of compliance cost and uncertainty than the current set of rules—and to base those suggestions on an analysis that may prove useful in promoting further development as the environment changes over time.