COMMENT

TRANSFER PRICING, SECTION 482, AND INTERNATIONAL TAX CONFLICT: GETTING HARMONIZED INCOME ALLOCATION MEASURES FROM MULTINATIONAL CACOPHONY

ROBERT G. CLARK

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INTRODUCTION

Since the end of World War II, national economic policies have become increasingly interdependent as countries have derived ever greater economic vitality from the strengths and weaknesses of their trading partners.\(^1\) Indeed, the rise of the “new world order” may replace the military might and strategic alliances that marked the cold war era with economic power and trade blocs.\(^2\) One manifestation of this economic globalization is the rise of multinational businesses that establish numerous subsidiaries or affiliated companies in various countries.\(^3\) Although many reasons exist for multina-
tional diversification, the existence of multinational corporations may highlight differences between the countries in which multinationals establish their subsidiaries.4

One of the more difficult problems facing multinational businesses is the prospect of double taxation.5 As the term suggests, double taxation occurs when two or more countries claim jurisdiction to tax the same income.6 Where uncertainty exists as to which of two affiliated or commonly controlled companies in different countries has earned taxable income to which both companies have contributed, both countries might tax the same income.7 The affiliated group therefore may suffer tax liability in two different tax jurisdictions.8

Double taxation generally occurs in the context of transfer pricing adjustments, where tax authorities in competing jurisdictions disagree over income allocations attributable to transfer pricing.9 Transfer pricing adjustment, at income allocation, is the means by which national tax authorities assign market prices to related-party

(1989) (asserting that international movement of technology, people, goods, services, and corporate capital is modern norm).


5. See MULTINATIONAL CORPORATIONS IN WORLD DEVELOPMENT, supra note 4, at 67 (stating that although all countries have right to tax income earned within their borders, some also claim right to tax income earned in other countries by entities that are domiciled within their jurisdiction). In the case where a country taxes income according to domicile, the home country’s taxation of foreign income will result in double taxation. Id.

6. See James R. Mogle, Competent Authority Procedure, 23 GEO. WASH. J. INT’L L. & ECON. 725, 725 (1990) (defining point at which double taxation occurs and discussing means for eliminating it). The United States, for example, may tax all of a U.S. citizen’s income, regardless of the income’s place of origin. See Cook v. Tait, 265 U.S. 47, 56 (1924) (upholding congressional power to tax foreign-source income earned by nonresident citizen). Thus, a U.S. company whose own income is generated by an overseas affiliate must pay U.S. income tax not only on its domestic income, but on any dividends paid to it by the foreign affiliate as well. See Kaplan, supra note 4, at 303 (noting that United States taxes dividends paid by foreign subdivision to U.S. parent).

7. See Kaplan, supra note 4, at 300-01 (explaining that national tax authority’s concerns ordinarily are limited to corporate unit located within its jurisdiction without consideration of fact that unit’s income may also be taxable in another jurisdiction).


9. See Mogle, supra note 6, at 725 (discussing requisite conditions for double taxation disputes and observing that double taxation commonly occurs as result of related-party transfers). Double taxation exists because tax authorities often employ different methods for determining the appropriate income allocations attributable to transfers between related parties. See infra text accompanying notes 15-39 (discussing arm’s length standard and alternate means of attributing transfer prices to intracorporate transfers).
transactions in order to clarify the income attributable to each segment of a multinational corporation, thereby performing the role reserved to the free market in transactions among unrelated parties.\textsuperscript{10} When unmitigated double taxation occurs,\textsuperscript{11} the taxpayer ordinarily has recourse only to obtain agreement on its behalf between the two countries' tax authorities.\textsuperscript{12} In many cases, however, the

10. See Kaplan, \textit{supra} note 4, at 300-03 (illustrating market role in unrelated-party transfers and transfer pricing role in related-party transfers); Mary L. Dionne, \textit{Book Review}, 55 Tax Notes 1279, 1279 (1992) (reviewing \textit{Ernst \& Young et al., International Transfer Pricing} (1992)) (discussing I.R.C. § 482, which permits Secretary of Treasury to allocate income earned by commonly controlled parties in transactions with one another, so as to reflect market prices for similar transactions); see also Karen S. Cravens \& Howell J. Lynch, Jr., \textit{The Spanish Inquisition: Transfer Pricing Implications of the Tax Court Decision in Procter \& Gamble, 39 Oil. \& Gas Tax Q. 380, 380-81} (1991) (suggesting that related entities may compete in ways that shift disproportionate income to certain members of related group).


Lest the reader become alarmed, it is important to note that double taxation is the exception and not the rule. In the vast majority of cases involving both foreign and domestic income, provisions built into national tax laws mitigate or eliminate double taxation. See Julie A. Roin, \textit{The Grand Illusion: A Neutral System for the Taxation of International Transactions}, 75 Va. L. Rev. 919, 923-26 (1989) (summarizing tax exemptions and tax credit mechanisms for alleviating double taxation); see also I.R.C. § 901 (1988) (codifying foreign tax credit). The most common methods for alleviating double taxation are the tax exemption, whereby a country exempts foreign-source income from its cumulative tax base, and the tax credit, which permits a taxpayer to subtract income taxes paid in a foreign country from its domestic tax liability. Roin, \textit{supra}, at 923-24. A potential third method for alleviating double taxation would be to permit the taxpayer a deduction from profits subject to tax in its country of domicile. See J.D.R. Adams \& J. Whalley, \textit{The International Taxation of Multinational Enterprises in Developed Countries} 46 (1977) (noting third method for alleviating double taxation, tax deduction, which allows amount of foreign tax to be deducted from tax base of country in question). Such a deduction scheme, however, probably would not provide the same benefits offered by exemption and credit. \textit{Id.; Treasury Department's Model Income Tax Treaty of June 16, 1981: Convention Between the United States of America and for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital}, 1 Tax Treaties (CCH) ¶ 211, at 10,573, 10,577 [hereinafter \textit{U.S. Model Convention}] (incorporating provisions of statutory foreign income tax credit).

12. See \textit{infra} notes 292-315, 333-47 and accompanying text (illustrating incorporation of dispute resolution procedures into tax treaties). Most bilateral income tax treaties, as well as a number of model double taxation conventions, provide bilateral means for resolving double taxation. See Mogle, \textit{supra} note 6, at 725 (noting that most U.S. income tax treaties and bilateral tax treaties among OECD members, as well as model double taxation conventions adopted by United Nations, provide means for eliminating double taxation); see also \textit{Organisation for Economic Co-operation \& Dev. Comm. on Fiscal Affairs, Model Double Taxation Convention on Income and on Capital} art. 25, at 42 (1977) [hereinafter OECD Model Convention] (providing means, including competent authority procedure, for resolving double taxation disputes); U.N. Dep't of Int'l Economics \& Social Affairs, U.N. Model Double Taxation Convention Between Developed and Developing Countries art. 25, at 40, U.N. Doc. ST/ESA/102, U.N. Sales No. E.80.XVI.3 (1980) [hereinafter U.N. Model Convention] (utilizing competent authority procedures to resolve instances of double taxation); \textit{U.S. Model Convention}, \textit{supra} note 11, art. 25, at 10,543 (providing mutual agreement procedure for interpreting or applying bilateral tax agreements and avoiding problems such as double taxation).
means employed to settle such disputes may be cumbersome, overly burdensome for the taxpayer, or may bear little or no binding effect on future tax relations between the countries involved.\textsuperscript{13}

This Comment discusses the process of resolving double taxation disputes in light of the issues relevant to transfer pricing. Part I examines the international standard for determining appropriate prices and for allocating the amount of income properly attributable to cross-border dealings among related parties. This section also illustrates instances that may lead to transfer pricing adjustments, while discussing the history and application of the existing international standard as articulated by the Organisation for Economic Co-operation and Development (OECD), the United Nations, and the United States. In addition, Part I explores the means by which the United States has historically implemented the international standard, illustrating the general application of the international standard and highlighting some of the difficulties inherent in its application. Part II discusses recent amendments to the principal United States transfer pricing statute\textsuperscript{14} and the international reaction to the regulations that have evolved under the statutory amendment. This section includes analysis of the rationale underlying the statutory amendment, the process through which the Internal Revenue Service (IRS) developed the new regulations, the new regulations themselves, and the extent to which the new regulations' proposed methodology may conflict with methods employed by tax authorities in other nations. This discussion makes detailed references to the particular problems associated with determining the value of intangible property and the means by which the new rules purport to standardize valuation methods specific to intangibles. Finally, Part III examines existing dispute resolution mechanisms as well as the limitations of the international transfer pricing standard. This section discusses the relative benefits of existing provisions for competent authority proceedings, advance pricing agreements, and limited arbitration, and explores the potential for binding international arbitration that could unify international transfer pricing standards through bilateral and multilateral agreement.

I. THE ARM'S LENGTH STANDARD

Intracorporate transfers, or trade among entities that share com-


\textsuperscript{14} See I.R.C. § 482 (1988) (regulating intercompany transfer pricing allocations by Secretary of Treasury).
mon or centralized management,\textsuperscript{15} are not inherently problematic. Rather, they are a requisite to doing business within a multinational corporate structure.\textsuperscript{16} These transfers, however, occur without the benefit of a free market.\textsuperscript{17} Unrelated companies in competition with each other trade goods and services at rates of consideration that are set by market forces.\textsuperscript{18} In contrast, related companies that have no need to compete with each other are not significantly affected by the market.\textsuperscript{19} A company that benefits, for example, from the increased profitability of its subsidiary has little incentive to charge that subsidiary a fair market price for goods, services, or intangible property.\textsuperscript{20} If the parent company were to manipulate its transfer prices so as to reduce its overall income tax exposure, its actions may constitute tax avoidance and therefore detract from the revenue base of a country in which it does business.\textsuperscript{21}

The problem with intracorporate transfers becomes evident when the transfers are made between related parties that are incorporated in different countries and operate under different national tax laws.\textsuperscript{22} Most developed nations, the United States foremost among

\textsuperscript{15} See Cravens & Lynch, supra note 10, at 380 (noting that transfer pricing issues arise with respect to divisions or profit centers within company or between affiliated companies).


\textsuperscript{17} See 1979 OECD Report, supra note 16, at 7 (positing that intracorporate transfers are not governed by same forces as transfers between unrelated parties); Kaplan, supra note 4, at 300 (asserting that free market has minimal effect on transactions between two parts of same corporate taxpayer); cf. Adam Smith, Selections from The Wealth of Nations 38-47 (George J. Stigler ed., 1957) (explaining effects of free market externalities on sale price of marketed goods).

\textsuperscript{18} A vendor ordinarily will seek the highest available price for its products, while a purchaser will seek the lowest available price. See Kaplan, supra note 4, at 300 (noting that free market sets appropriate prices for unrelated-party transactions).

\textsuperscript{19} Kaplan, supra note 4, at 300. The IRS defines a related party, or "controlled taxpayer," as "any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests." Temp. Treas. Reg. § 1.482-1T(g)(5), 58 Fed. Reg. 5263, 5282 (1993). This element of control is determined by the relationship's operative effect rather than by its form or mode of existence. Id. § 1.482-1T(g)(4), 58 Fed. Reg. at 5282.

\textsuperscript{20} See Cravens & Lynch, supra note 10, at 381 (asserting that economic entities ordinarily strive to "buy low" and "sell high," but that related entities are not fully motivated to do so).

\textsuperscript{21} See Kaplan, supra note 4, at 301 (noting that multinational enterprises seek to minimize global tax burdens by manipulating prices for goods, services, or other assets, resulting in reduction of government's revenue base).

\textsuperscript{22} See 1979 OECD Report, supra note 16, at 7 (indicating that transfers between related international entities create problems of conflicting national laws of countries in which entities operate). In a purely domestic context, intracorporate transfers generally amount to a "zero sum game," wherein one party's gain will offset exactly the other's loss, and all income attributable to the corporation will be taxed under the same national tax laws. Kaplan, supra note 4, at 300. Although state, provincial, or local income tax laws differ in a domestic setting, transfer pricing is not a major issue in those contexts because such tax differences are
them, have addressed this problem by implementing comprehensive transfer pricing rules that are intended to correct deviations from market prices that may be evident in intracorporate transfers.23 In essence, transfer pricing adjustments assign a "price," used only for allocating taxable income, that most accurately reflects the amount that the same transferor would have charged an unrelated third party for the same goods or services.24 Although national rules vary widely in both scope and application,25 the international standard for transfer pricing is that of arm's length, or the consideration that would have been charged in the same transaction between unrelated parties dealing at arm's length.26

Regardless of the specific rule applied, the intent of transfer pricing is to ensure that taxable income is kept within reach of a nation's comparatively small. Kaplan, supra note 4, at 300 n.6; see also Edwards v. Commissioner, 67 T.C. 224, 224 (1976), aff'd, 531 F.2d 224 (1977) (addressing tax conflicts caused by transactions between commonly held corporation and partnership that were operating under different tax rates); Wickham & Kerester, supra note 13, at 341-42 (summarizing U.S. legal mechanisms aimed at eliminating domestic disputes involving related-party transfers); infra notes 101-08 and accompanying text (discussing Edwards). In an international context, however, intracorporate transfers take on greater tax significance. For example, a transfer of goods made by a U.S. corporation to a foreign subsidiary for no consideration would decrease that corporation's reported U.S. income while increasing the income reported by the subsidiary. If the subsidiary were located in a country with lower corporate income tax rates than the United States, the corporation would avoid a portion of its cumulative tax liability. See infra notes 40-58 and accompanying text (defining taxation problem arising from international intracorporate transfers and summarizing hypothetical tax-avoiding transfers among related parties).


24. See Wickham & Kerester, supra note 13, at 342 (observing that transfer pricing adjustment is based on hypothetical "price" to which unrelated parties would agree).

25. See CROSS-BORDER TRANSACTIONS, supra note 23, at 283-301 (highlighting features of various national tax rules).

26. See, e.g., Temp. Treas. Reg. § 1.482-1T(b)(1), 58 Fed. Reg. 5263, 5272 (1993) ("A controlled transaction meets the arm's length standard if the results of that transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances."); OECD Model Convention, supra note 12, art. 9, at 30 (providing arm's length standard as means for contracting states to convention to reallocate profits among associated enterprises for tax purposes); U.N. Model Convention, supra note 12, art. 9, at 27 (including as taxable profits those profits that would have accrued from transactions had they been made between independent enterprises); see also 1979 OECD REPORT, supra note 16, at 7 (explaining that arm's length standard corresponds to prices charged in transactions among unrelated parties); CROSS-BORDER TRANSACTIONS, supra note 23, at 284 (illustrating that 24 of 25 industrialized nations have adopted arm's length standard for determining transfer prices); U.N. Tax Treaties, supra note 23, at 62 (claiming unanimous international agreement on arm's length standard); Rom Watson, New Developments, in TAX ON THE INTERNATIONAL TRANSFER OF INFORMATION 75, 76 (David W. Williams ed., 1991) (noting that United States has uniformly adopted arm's length standard in bilateral income tax treaties and model treaties).
Although transfer pricing regulations operate by allocating income earned among related segments of multinational entities, their purpose has less to do with distributing multinational taxpayers' income than with distributing tax revenue among the nations in which those taxpayers do business. While a national revenue authority bears considerable responsibility for enforcing its own tax laws, it must also contend with the possibility that another nation's tax laws may conflict with its own, thereby competing for a common revenue pool. Furthermore, while a country must prevent undertaxation of income earned within its jurisdiction, it must also prevent the overtaxation of its taxpayers by the operation of other countries' transfer pricing laws.

The problems associated with competing tax jurisdictions create the greatest obstacles to establishing fair and uniform international transfer pricing standards. Although the OECD, United Nations, and United States have adopted model conventions that address transfer pricing adjustments, and although the standards set forth therein have received nearly unanimous international support, the application of the arm's length standard imposes many difficulties. For instance, the prospect of applying a fixed price to a transaction that unrelated parties do not ordinarily undertake or that involves unique (and therefore unpriceable) goods, services, or intangible property is daunting to say the least.

Where tax authorities of two or more countries have an interest in the income of the same enterprise but apply different standards for

27. See Wickham & Kerester, supra note 13, at 341-43 (stating that intent of every government in implementing transfer pricing rules is to avoid losses of legitimate tax revenues).
28. See Wickham & Kerester, supra note 13, at 343 (recognizing that one purpose of transfer pricing is geographic sourcing of income to allocate tax revenue among competing nations).
29. See 1979 OECD REPORT, supra note 16, at 8 (suggesting that one nation's aggressive taxation of foreign-derived income may harm other involved nation's tax base).
30. See Wickham & Kerester, supra note 13, at 341 (stating that purposes of transfer pricing regulations are to protect national fisc, to ensure that foreign businesses do not obtain unfair tax advantages, and to prevent nationals from paying discriminatory foreign taxes).
31. See Wickham & Kerester, supra note 13, at 343 (characterizing existing international standard as biased toward unilateral tax enforcement rather than mutual agreement).
32. OECD MODEL CONVENTION, supra note 12, art. 9, at 30; U.N. MODEL CONVENTION, supra note 12, art. 9, at 27; U.S. Model Convention, supra note 11, art. 9, at 10,577.
33. See supra note 26 and accompanying text (documenting international acceptance of arm's length standard).
34. See 1979 OECD REPORT, supra note 16, at 13-22 (setting forth problems encountered in applying conventional transfer pricing methodologies); see also Stanley I. Langbein, The Unitary Method and the Myth of Arm's Length, 80 Tax Notes 625, 625-29 (1986) (suggesting that arm's length standard should not restrict governments' ability to employ any appropriate transfer pricing allocation method).
35. See David W. Williams, Introduction to TAX ON THE INTERNATIONAL TRANSFER OF INFORMATION 1, 1-2 (David W. Williams ed., 1991) (illustrating difficulty of valuing property with example of IBM's purchase of rights to first programmable computer for only £50,000).
determining arm's length prices and therefore make different adjustments to the same transactions, those countries will assign different tax liabilities to those transactions. Consequently, the multinational enterprise involved in such a transaction may be taxed twice. To resolve this double taxation problem, the U.N. Model Convention and the OECD Model Convention provide dispute resolution procedures. The fact that double taxation still occurs, however, indicates the need for more effective dispute resolution methods, or more importantly, a revised international standard.

A. The Problem Defined

In a 1979 report, the OECD Committee on Fiscal Affairs stated that the phenomenon of related companies operating in concert under some form of central management, but under different national tax laws, naturally gives rise to problems in taxing corporate profits. Although that observation was not new, the increase in the number and influence of multinational corporations in recent decades has made transfer pricing an increasingly relevant concern for tax authorities, which in some cases are dissatisfied with the efficacy of the traditional arm's length standard.

Although transfer pricing questions arise in many different contexts, a few hypotheticals are helpful in understanding the general problem. The following hypotheticals illustrate situations that may be referred to as income expatriation, income repatriation, and round-trip transfers. For simplicity, each example assumes that the inter-

36. See 1984 OECD REPORT, supra note 11, at 9 (introducing concept of "corresponding adjustments," or modifications made by tax authorities of different nations with regard to single transaction).
37. See 1984 OECD REPORT, supra note 11, at 11 (recognizing double taxation as natural consequence of unilateral transfer pricing adjustments).
38. See OECD MODEL CONVENTION, supra note 12, art. 25, at 42 (establishing competent authority negotiations as means to reach mutual agreements); U.N. MODEL CONVENTION, supra note 12, art. 25, at 40 (providing competent authority procedures as dispute resolution means).
39. See infra notes 292-347 and accompanying text (discussing existing and proposed means for avoiding and resolving double taxation).
41. See 1979 OECD REPORT, supra note 16, at 7 (observing increasing role of multinational economic entities in global affairs).
43. The first of the following hypotheticals has been adapted from Kaplan, supra note 4, at 301-03. The remaining hypotheticals have been constructed by the author, with reference to the sources noted.
44. See 58 Fed. Reg. 5263, 5264 (1993) (comments to temporary regulations) (discussing round-trip transactions). The terms "income expatriation" and "income repatriation" are the author's.
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ested tax authority is the IRS.

1. Expatriating income to a foreign affiliate

In the first example, a U.S. corporation, X, manufactures a product, which sells for a wholesale price of $10, at a unit cost of $2. The corporation ordinarily would sell the product to its distributors for $10, thereby earning taxable income of $8 for each item sold. Rather than sell the product on its own and be subject to income tax on all of its $8 profit, however, X sells to a wholly owned foreign subsidiary at a price of $4 per unit. The subsidiary then merely distributes the product at the unit price of $10.\footnote{See Kaplan, supra note 4, at 301-03 (offering hypothetical and discussing income expatriation).}

The result of this hypothetical is that X realizes a net profit of $2 per unit sold, while its foreign subsidiary realizes a profit of $6 per unit. Because the subsidiary is wholly owned by X, its parent's balance sheet will reflect its profits, meaning that X has realized an actual profit of $8 per unit—the same as if it had sold the product on its own.\footnote{Kaplan, supra note 4, at 302.} Under this distribution scheme, therefore, X has diverted 75% of its income to a foreign tax jurisdiction. If that jurisdiction assesses a lower corporate tax rate than the United States, X has successfully avoided a significant portion of its cumulative tax burden.\footnote{See Kaplan, supra note 4, at 302 (noting that parent company will have incentive to arrange income transfer scheme where there is large difference between tax rates in two countries). More often than not, the incentive to enter this tax avoidance scheme is provided by favorable corporate income tax rates in the country where the subsidiary is located. Cravens & Lynch, supra note 10, at 382. For example, if in the above hypothetical the country in which the subsidiary does business has no corporate income tax, X will have avoided 75% of its tax liability.}

2. Repatriating income to a foreign parent

In the second hypothetical, a foreign parent corporation maintains a wholly owned manufacturing subsidiary, or "screwdriver plant,"\footnote{See U.S., Others Blame EC for Failure in Brussels to Agree on New Rules To Govern World Trade, [July-Dec.] Int'l Trade Rep. (BNA) No. 49, at 1876, 1879 (Dec. 12, 1990) (defining and discussing "screwdriver plant" as nonintegrated product assembly plant that foreign manufacturer establishes in importing country).} and supplies this subsidiary with component parts for the sole purpose of assembling the finished product. Assuming that the parent corporation is located in a favorable tax jurisdiction,\footnote{Cf. Kaplan, supra note 4, at 302 (discussing hypothetical involving sales to subsidiary located in country that imposes no income tax).} the following occurs: rather than sell component parts to the subsidiary at market or below-market prices, as in the previous hypothetical,
the parent "sells" component parts to its subsidiary at prices so inflated that in spite of the subsidiary's success at producing and marketing its product, the subsidiary earns less than expected or even loses money.\(^50\) By overcharging for the parts, the parent has in effect repatriated its earnings before they were earned and thus has avoided generating income, or income tax liability, within the United States.\(^51\)

3. *Round-trip transfers of intangible property*

In the third example, the property transferred is not components or finished products, but an intangible such as intellectual property.\(^52\) In this case, a U.S. parent company licenses the intangible to its foreign subsidiary, which uses the intangible to manufacture a product.\(^53\) The subsidiary then sells the product back to the parent company or to other affiliates, or markets the product independently.\(^54\)

This hypothetical differs from the previous two in several key respects. First, the subsidiary has not taken advantage of material value that its parent has added to a finished product. Rather, it has employed only the intangible provided to it by the parent. Second, in selling the product back to the parent company or to another affiliate, the subsidiary need only charge an appropriate market price.\(^55\) As far as the IRS is concerned, the operative segment of the

\(^{50}\) *See*, e.g., *Yamaha Motor Corp., U.S.A. v. Commissioner*, 63 T.C.M. (CCH) 2176, 2176-77 (1992) (acknowledging IRS assertion that petitioner's low operating income was due to non-arm's length purchases of components from foreign parent); Alan F. Holmer et al., *U.S. Trade Law and Policy Series No. 17: Steering Clear of the Scylla of the U.S. Antidumping Law and the Charybdis of Internal Revenue Code Section 482*, 24 Int'l L. & Pol'y 1099, 1102 (1990) (discussing IRS authority to adjust prices where foreign company has overcharged U.S. affiliate).

\(^{51}\) Such a scheme has been the subject of IRS investigations into Japanese automobile manufacturers' dealings with their U.S. subsidiaries. John H. Fisher, Comment, *I.R.C. Section 482—Applying the Arm's Length Standard to Transactions Between Foreign Car Manufacturers and Their United States Subsidiaries*, 4 Wis. Int'l L.J. 134, 148-49 (1985); see also *United States v. Toyota Motor Corp.*, 561 F. Supp. 354, 358 (C.D. Cal. 1983) (reasoning that § 482 permits adjustment of U.S. subsidiary's income where income had flowed from subsidiary to foreign parent); *Yamaha Motor Corp.*, 63 T.C.M. (CCH), at 2178 (noting IRS's authority to allocate income under § 482 to U.S. subsidiary with foreign parent).

\(^{52}\) *See* 58 Fed. Reg. 5263, 5264 (1993) (comments to temporary regulations) (explaining "round-trip" transaction as "integrated series of controlled transactions" involving intangible property).

\(^{53}\) *Id.* This hypothetical assumes that the subsidiary has provided or otherwise paid market rates for all raw materials, equipment, and other manufacturing costs involved in producing the finished product.

\(^{54}\) *Id.*

\(^{55}\) The reader should note that if the subsidiary sold the product to its U.S. parent at a price below market rate, thereby inverting the first hypothetical discussed above, the non-arm's length resale would increase the parent's U.S. income and potentially expose the company to a transfer price allocation by the subsidiary's country of residence. *See supra* notes 22-39 and accompanying text (explaining application of transfer pricing adjustment to transactions carried on between related parties).
transaction is the initial license to the subsidiary, and any pricing adjustment must accordingly reflect a royalty that might properly be charged for the license.\textsuperscript{56} Finally and most importantly, the parties may not have known the ultimate value of the intangible at the time of transfer. Unlike the first two hypotheticals, which involved transfers of tangible goods for which market prices may be available, the value of a newly developed patent is generally speculative.\textsuperscript{57} It is this type of transaction and the extraordinary valuation problems associated with it that led Congress to address the subject of controlled transfers of intangibles in the Tax Reform Act of 1986.\textsuperscript{58}

\textbf{B. The History of the Arm's Length Standard}

In 1921, Congress permitted the Commissioner of Internal Revenue to require consolidated tax returns from affiliated domestic corporations if necessary to determine a taxpayer's total taxable income.\textsuperscript{59} Congress did not directly address the question of tax evasion through related-party transfers until it passed the Revenue Act of 1928,\textsuperscript{60} which permitted the Commissioner to allocate or apportion the incomes of related entities to reflect their true tax liabilities.\textsuperscript{61} The legislative history of the Revenue Act of 1928 evidences clear congressional intent to discourage tax evasion through intra-corporate transfers,\textsuperscript{62} and the language of section 45 of the Act has survived with only cosmetic changes as the first sentence of \$ 482 of

\textsuperscript{56} See I.R.C. \$ 482 (1988) (requiring that price or royalty charged in controlled transaction correspond to income ultimately realized from exploitation of intangible).

\textsuperscript{57} See H.R. Rep. No. 426, supra note 42, at 424 (discussing problem of valuing intangible property and asserting need for periodic review of realized profits and comparison to original price charged); Williams, supra note 35, at 1-2 (noting difficulty of valuing knowledge or intelligence and fact that parties may not even be aware of intangible property's transfer).


\textsuperscript{59} See Revenue Act of 1921, ch. 136, 42 Stat. 227, 260 (authorizing Commissioner of IRS to "consolidate the accounts of such related trades and businesses ... for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses"); see also A Study of Intercompany Pricing Under Section 482 of the Code, I.R.S. Notice 88-123, 1988-2 C.B. 458, 459 [hereinafter White Paper] (tracing history of transfer pricing law and noting that income tax statutes dating back to 1917 indirectly related to income allocation between affiliated corporations).

\textsuperscript{60} Ch. 852, 45 Stat. 791 (1928).

\textsuperscript{61} Id. \$ 45, 45 Stat. at 806.

\textsuperscript{62} See H.R. Rep. No. 2, 70th Cong., 1st Sess. 16-17 (1927) (declaring that intent of provision was to "prevent evasion (by shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect ... true tax liability").
the current Internal Revenue Code.63

In 1963, as Congress first became concerned with the transfer pricing problems associated with multinationals,64 the OECD articulated an international transfer pricing standard in article 9 of a draft model convention on double taxation.65 Despite a fair amount of commentary on the transfer pricing standard,66 the OECD did not formally adopt the draft text until 1977.67 Three years later the

65. Congress altered the language slightly (but not substantively) and changed the section number to 482 in the Internal Revenue Code of 1954, ch. 736, § 482, 68A Stat. 3, 162 (codified as amended at 26 U.S.C. § 482 (1988)). The regulations issued in 1935 under section 45, Treas. Reg. 86, § 45-1(b) (1935), remained unaltered until 1968, when the Treasury Department amended the regulations to address transfers among multinational enterprises in a more complete fashion. See White Paper, supra note 59, at 460 (discussing history of § 482 and regulatory amendments in 1960s); see also infra notes 130-53 and accompanying text (discussing evolution of “commensurate with income” standard).


67. ORGANISATION FOR ECONOMIC CO-OPERATION & DEV. COMM. ON FISCAL AFFAIRS, OECD DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL 13 (1963) [hereinafter 1963 CONVENTION]; see 1979 OECD REPORT, supra note 16, at 10 n.1 (noting that article 9 was carried from 1963 Convention to OECD Model Convention without change); U.N. MODEL CONVENTION, supra note 12, art. 9, at 27 (reproducing article 9 of OECD Model Convention).

Article 9 provides:

1. 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 an enterprise of the other 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 not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

1963 CONVENTION, supra, art. 9, at 13; OECD Model Convention, supra note 12, art. 9, at 30; U.N. MODEL Convention, supra note 12, art. 9, at 27.


67. See 1979 OECD REPORT, supra note 16, at 10 n.1 (noting that article 9 was carried
United Nations likewise adopted a model convention on double taxation.  

Although the model conventions adopted by the OECD and the United Nations employ identical language in addressing related-party transactions, and although both endorse the arm's length standard, neither prescribes empirical methods for determining an arm's length price. Practical methods for calculating an arm's length price had already been implemented in the United States, however, by amendments in 1968 to the Treasury regulations under § 482.  

C. Adjusting Income Under the Arm's Length Standard

In theory, applying the arm's length standard is relatively easy.
Prices charged among related parties simply must be adjusted to reflect arm’s length prices, which are defined as prices that unrelated parties charge each other in the market.\textsuperscript{73} In practice, however, this apparent simplicity disappears. To determine market rates for property transfers, the property in question must be substantially similar or comparable to property commonly traded among unrelated parties.\textsuperscript{74} Where transfers defy definition by the market, as do transfers involving proprietary goods or valuable intellectual property that would not ordinarily be the subject of a transaction among unrelated parties, a tax authority must turn to alternative methods for establishing their value.\textsuperscript{75} The principal pricing methods that tax authorities use, in an order determined by a transaction’s relative comparability to a third-party transaction,\textsuperscript{76} are the comparable uncontrolled price,\textsuperscript{77} resale price,\textsuperscript{78} and cost plus methods.\textsuperscript{79}

\textbf{1. Comparable uncontrolled price}

In any tax system that relies on the arm’s length standard, the preferred method to determine a transfer price adjustment is to compare a related-party transaction with a substantially identical transaction between unrelated parties.\textsuperscript{80} Ideally, a related-party transaction will substantially, if not exactly, resemble a similar transaction between unrelated parties. In such a situation, the “comparable uncontrolled price” method for determining the appropriate

\textsuperscript{73} See Temp. Treas. Reg. § 1.482-1T(b)(1), 58 Fed. Reg. 5263, 5272 (1993) (“In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with another uncontrolled taxpayer.”).

\textsuperscript{74} See Charles H. Berry et al., \textit{Arm’s-Length Pricing: Some Economic Perspectives}, 54 Tax Notes 731, 733 & n.6 (1992) (recognizing that in determining transfer price, issue is whether property is sufficiently similar so that adjustments for differences may be made).

\textsuperscript{75} See 1979 OECD Report, supra note 16, at 13 (noting that certain types of property are so special that there may be no market for them outside related-party group). In situations involving special property, arm’s length prices may be determined by using the cost plus method or the resale price method. Id. at 14; see infra notes 90-108 and accompanying text (discussing cost plus and resale price methods).


\textsuperscript{77} See 1979 OECD Report, supra note 16, at 13 (defining “comparable uncontrolled price” method as requiring comparison to prices in similar transaction between independent parties or between group enterprise and unrelated parties); see also infra notes 80-89 and accompanying text (discussing comparable uncontrolled price method).

\textsuperscript{78} See 1979 OECD Report, supra note 16, at 13-14 (explaining resale price method as subtracting cost and appropriate profit markup from final price at time of sale); see also infra notes 90-98 and accompanying text (discussing resale price method).

\textsuperscript{79} See 1979 OECD Report, supra note 16, at 13-14 (explaining cost plus method as adding appropriate costs and profit markup to cost of providing goods and services); see also infra notes 99-108 (discussing cost plus method).

\textsuperscript{80} See 1979 OECD Report, supra note 16, at 13 (referring to comparable uncontrolled price method as the “most appropriate to use and in theory the easiest”).
arm's length price merely involves comparing the price charged in the related parties' transaction to prices charged in similar transactions between independent parties or between the group enterprise and unrelated parties.81

Not every related-party transaction, however, bears a reasonable resemblance to transactions occurring in the market. Even apparently identical third-party transactions may not meet the arm's length standard under the comparable uncontrolled price method.82 For example, in the case of United States Steel Corp. v. Commissioner,83 the Tax Court examined the relationship between a U.S. corporation and its foreign shipping subsidiary, which provided transport for iron ore supplied by a second foreign subsidiary.84 Despite the fact that the shipping subsidiary charged third-party purchasers of foreign ore the same rate that it charged the parent,85 the court did not agree that the third-party transactions adequately reflected market rates.86 United States Steel therefore raises the difficult problem of defining the phrase "comparable uncontrolled transaction."87 At a minimum, the Tax Court's decision in the case, when considered together with the U.S. Court of Appeals for the Second Circuit's reversal,88 indicates that even where identical third-party transac-

82. See 1979 OECD REPORT, supra note 16, at 13 (recognizing that some transactions are difficult to compare because they involve special property that has no market beyond related party).
83. 36 T.C.M. (CCH) 586 (1977), rev'd, 617 F.2d 942 (2d Cir. 1980).
84. United States Steel Corp. v. Commissioner, 36 T.C.M. (CCH) 586, 588 (1977), rev'd, 617 F.2d 942 (2d Cir. 1980). The IRS concluded that the shipping subsidiary was charging inflated rates and allocated 25% of the transportation charges paid by U.S. Steel to the subsidiary. Id. at 605.
85. Id. at 588.
86. Id. at 602-03 (asserting that independent purchaser of ore could obtain lower shipping rate).
87. See Gale Mosteller, Comparability in the U.S. Steel Transfer Pricing Case, 55 TAX NOTES 1251, 1253 (1992) (noting that regulations provide little guidance for identifying comparable transactions).
88. United States Steel Corp. v. Commissioner, 617 F.2d 942, 954 (2d Cir. 1980). The appellate court reversed the tax court's decision because it found sufficient evidence to prove that the price the producer paid was arm's length. Id. at 947. The appellate court found that the shipping subsidiary charged U.S. Steel approximately the same price that it charged unrelated parties for similar transactions. Id. Therefore, the court did not reallocate income to U.S. Steel's subsidiary under § 482. Id.

Some analysts, however, assert that the Second Circuit was incorrect. See, e.g., Mosteller, supra note 87, at 1254 (asserting that Second Circuit decision was wrong because it rejected "analyzing the context of the transaction [such as buyer's alternatives] when it indicated that the key issues were whether the transactions involved similar services and whether the transactions were independent"). But see Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525, 590 (1989) (following Second Circuit's analysis of comparable uncontrolled prices and abandoning its earlier approach in United States Steel), aff'd, 933 F.2d 1084 (2d Cir. 1991).
tions exist, the circumstances of those transactions must be subjected to complex judicial scrutiny and might not serve properly as comparable uncontrolled transactions. 89

2. Resale price

Where comparable uncontrolled prices are not available, the next-favored technique for determining an adjustment is the resale price method. 90 This method requires ascertaining a market-based resale price 91 and subtracting an appropriate profit to obtain a reasonable arm's length price. 92 The steps involved in determining a proper transfer price under this method reveal that the resale price

89. See Mosteller, supra note 87, at 1254 (suggesting that reviewing suitability of comparable uncontrolled transactions requires analysis of at least: "(1) the product or service and the terms of the transaction; (2) the buyer's alternatives; and (3) the seller's alternatives"); see also United States Steel Corp. v. Commissioner, 36 T.C.M. (CCH) 586, 603 (1977) (reducing analysis to similar three-part inquiry), rev'd, 617 F.2d 942 (2d Cir. 1980).

Acknowledging that the single largest unrelated purchaser of Venezuelan ore from U.S. Steel's subsidiary had arranged its own transportation, presumably at a lower rate than that offered by U.S. Steel's shipping subsidiary, United States Steel, 36 T.C.M. (CCH) at 602, and that U.S. Steel could have contracted cheaper shipping by dealing with unrelated shipping contractors, id. at 604, the Tax Court concluded that the subsidiary charged its parent, U.S. Steel, higher rates than it would have charged an unrelated party for similar services. Id. at 602-04. After calculating factors specific to the shipping arrangement, the court found that the subsidiary had in fact overcharged U.S. Steel, and it adjusted U.S. Steel's income accordingly. Id. at 586, 605.


91. See Temp. Treas. Reg. § 1.482-3T(c)(2)(ii), 58 Fed. Reg. 5263, 5283 (1993) (defining applicable resale price as either resale price of property to unrelated party or contemporaneous resale price of same property). Under the 1968 regulations, the method applied only if there were no comparable uncontrolled prices, an appropriate resale price could be ascertained, and the reseller had not added significant value to the product before reselling it. Treas. Reg. § 1.482-2(c)(3)(ii) (as amended in 1988); see also Bausch & Lomb Inc. v. Commissioner, 92 T.C. 525, 586-87 (1989) (acknowledging regulatory requirements for applying resale price method), aff'd, 933 F.2d 1084 (2d Cir. 1991).

92. See Temp. Treas. Reg. § 1.482-3T(c)(2)(iii), 58 Fed. Reg. 5263, 5283-84 (1993) (explaining calculations of appropriate gross profit). Accurate administration of the resale price method also requires incorporation of any adjustments necessary to reflect material differences in the terms of the uncontrolled resales referred to in calculating the appropriate resale price and the terms of the resale in the controlled transaction. See id. § 1.482-3T(c)(3)(ii), (4), 58 Fed. Reg. at 5284 (requiring adjustment to account for material differences between controlled and uncontrolled transactions and providing example of adjustment where related party warranted resold products but unrelated party did not); see also E.I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445, 449-54 (1979) (discussing application of resale price method), cert. denied, 445 U.S. 962 (1980); Paccar, 85 T.C. at 790, 792-98 (discussing resale price method).
method merely constructs an arm's length price where a transaction ordinarily might not occur between unrelated parties.\textsuperscript{93} As applied by the Treasury regulations, the appropriate resale price is either the price at which resales of the same property are made between unrelated parties, or the final resale price of the property in question.\textsuperscript{94} In addition, application of an "appropriate markup" requires comparison to the profit ratio realized on resales of similar property that is the subject of transactions among unrelated parties.\textsuperscript{95}

Accordingly, any application of the resale price method must make reference to comparable transactions undertaken by unrelated parties.\textsuperscript{96} To serve the needs of the methodology, appropriate comparable resales by unrelated parties must be sufficiently similar to those made by the related parties so that any substantive differences between the compared transactions may be accounted for accurately.\textsuperscript{97} Absent these circumstances, the resale price method ordinarily does not apply.\textsuperscript{98}

3. **Cost plus**

The third method, cost plus, applies to transactions in which a controlled transferee adds value to goods before reselling them.\textsuperscript{99} Determination of a transfer price by the cost plus method involves

\textsuperscript{93} See Temp. Treas. Reg. § 1.482-3T(c)(2)(i), 58 Fed. Reg. 5263, 5283 (1993) (explaining procedure for determining arm's length price under resale price method, which involves subtracting appropriate gross profit from appropriate resale price in transaction among related parties); see also id. § 1.482-3T(b), 58 Fed. Reg. at 5282 (noting that existence of comparable transaction between unrelated parties permits application of comparable uncontrolled price method).

\textsuperscript{94} Id. § 1.482-3T(c)(2)(ii), 58 Fed. Reg. at 5283.

\textsuperscript{95} Id. § 1.482-3T(c)(2)(iii), 58 Fed. Reg. at 5283-84; see E.I. Du Pont, 608 F.2d at 450-54 (discussing derivation of appropriate resale price markup from similar transactions involving unrelated parties).

\textsuperscript{96} See Temp. Treas. Reg. § 1.482-3T(c)(2)(i), 58 Fed. Reg. 5263, 5283-84 (1993) (requiring that gross profit margins used to determine appropriate resale price be derived from comparable uncontrolled sale); see also E.I. Du Pont, 608 F.2d at 451-54 (finding no comparable unrelated-party transaction to justify application of resale price method).

\textsuperscript{97} See Temp. Treas. Reg. § 1.482-3T(c)(2)(ii), 58 Fed. Reg. 5263, 5274 (1993) (providing that functional comparability does not require identical controlled and uncontrolled transactions, but rather that uncontrolled transaction provide "a reasonable and reliable benchmark" for determining arm's length price); id. § 1.482-3T(c)(2)(ii), 58 Fed. Reg. at 5284 (requiring "appropriate adjustments" in calculating profit margins to account for differences between controlled and uncontrolled transactions); see also Woodward Governor Co. v. Commissioner, 55 T.C. 56, 65 (1970), acq., 1971-2 C.B. 3 (asserting that resale price method applies only with reference to uncontrolled purchases and resales by same or similar reseller).


\textsuperscript{99} See id. § 1.482-3T(d)(1), 58 Fed. Reg. at 5285 (stating that cost plus method determines arm's length price by considering profit markup and providing that method ordinarily applies "in cases involving the manufacture, assembly, or other production of goods that are sold to related parties"). See generally 1979 OECD REPORT, supra note 16, at 13-14 (describing
adding the reasonable cost of production to an amount computed by multiplying the production cost by an appropriate gross profit markup. For example, in Edwards v. Commissioner the Tax Court examined a relationship between a partnership and a corporation that shared common owners. The Government contended that the partnership had made sales of construction equipment to the corporation at less than market prices. After quickly dismissing the comparable uncontrolled price and resale price methods, the court turned to the cost plus method. The court's analysis focused on constructing an appropriate gross profit percentage. In rejecting the Government's valuation of the transfers, the court asserted that the best indicator for a gross profit percentage would be the profits realized by the partnership in sales to unrelated parties.

4. “Other methods” and the problem of intangible property

Unfortunately, controlled transactions frequently occur that defy application of cost plus method; Fisher, supra note 51, at 144-46 (discussing calculation of arm's length prices under cost plus method).


102. Edwards v. Commissioner, 67 T.C. 224, 229 (1976), acq., 1977-2 C.B. 2. Although both entities were organized and operated entirely within the United States, the case provides an excellent illustration of the cost plus method.

103. Id. at 226-27 (charting equipment sold and sale prices involved in sales to corporation against prices charged in sales to unrelated parties and manufacturer's list prices for equipment). The IRS had allocated to the partnership the difference between the profit it would have realized had it charged market prices and the profit it actually reported. Id. at 229-30. The basis for the IRS income estimate was a gross profit percentage calculated with reference to third-party prices charged in sales of similar equipment that were reported by members of a trade organization, as well as the manufacturer's list prices for the equipment. Id. at 236.

104. Id. at 234 (citing lack of data reflecting sales to unrelated parties and lack of information on what adjustments were needed to reflect different properties and circumstances).

105. Id. (observing that corporation did not resell equipment).

106. See id. at 234-35 (addressing IRS application of cost plus method in determining original income allocation and holding that whenever possible, gross profit percentages should derive from uncontrolled sales of selling party rather than uncontrolled sales of third parties).

107. See id. at 236 (deciding to compute accurate average instead of relying on respondent's survey).

108. Id. at 236. The court rejected the IRS's gross profit percentage calculation because the survey from which the IRS had purported to derive standard prices charged by other companies did not necessarily provide a representative sample of the prices charged by all members of the industry. Id. The court suggested further that the IRS data provided no proof that the survey's “industry norm” bore any direct relation to the transactions in which the partnership had engaged. Id. Finally, the court rejected the use of manufacturers' list prices because they did not control the prices charged by the partnership or any other dealer. Id.
definition by one of the three methods. Transfer pricing methods that can adequately accommodate such circumstances, such as those where a transaction involves unique intangible property that is used to produce a unique product, thus far have eluded international consensus. Generally such transactions may be priced only on a tortuous case-by-case basis. Despite the difficulty involved in applying such case-specific methods, which the IRS refers to collectively as “fourth methods,” the General Accounting Office has reported that the IRS applies “fourth method analysis” twice as often as the comparable uncontrolled price method.

Moreover, allocations of income attributable to intangibles often cannot rely on similar transactions by unrelated parties. The 1968 regulations provided only summary information for treatment of intangibles. Thus, a price determination relied strongly on the circumstances of a transfer of the same or similar intangible property by the same transferor to an unrelated transferee. When such comparable transactions were unavailable or inappropriate, the old regulations did nothing more than suggest twelve factors that...

109. See 1979 OECD Report, supra note 16, at 14 (noting that because evidence of controlled transactions is often unavailable, many transactions cannot be defined).
110. See 1979 OECD Report, supra note 16, at 14 (admitting that complexities of day-to-day business conditions put many conceptual and practical difficulties in way of application of comparable uncontrolled price, resale price, or cost plus methods and recognizing that object of arm’s length paradigm is to find price acceptable for each specific case). The OECD’s principal guidelines suggest that “[a]ny method which is used will involve problems of judgement and the evaluation of evidence and it has to be recognized that the object of using it is to produce a figure which is acceptable for practical purposes.” Id. The 1968 Treasury regulations do shed a little more light on the subject, stating that in cases defying definition by comparable uncontrolled price, resale price, or cost plus method, some other “appropriate method” should be used. Treas. Reg. § 1.482-2(e)(1)(iii) (as amended in 1988).

Although the temporary regulations do provide a catchall provision that determines an appropriate arm’s length price by reference to component measures of profitability that are available from uncontrolled transactions, they do not pretend to provide for every possible situation. See Temp. Treas. Reg. § 1.482-5T, 58 Fed. Reg. 5263, 5290-93 (1993) (delineating comparable profits method); infra notes 198-217, 253-68 and accompanying text (discussing adoption of comparable profits method). The new regulations therefore permit recourse to “other methods” under certain circumstances. See Temp. Treas. Reg. §§ 1.482-3T(c), -4T(d), 58 Fed. Reg. at 5286-87, 5288-90 (setting conditions for application of fourth method valuation of tangible and intangible property).

111. White Paper, supra note 59, at 469.
113. See supra notes 52-58 and accompanying text (discussing round-trip transfers and difficulty encountered in valuing intangible property).
115. See id. (explaining comparable price method and noting that if similar transactions cannot be found, standard is amount that would have been paid by unrelated party for same property under same circumstances).
could be considered in determining an arm’s length price.\textsuperscript{116} Although the twelve factors did contemplate a failure to obtain satisfactory comparable transactions, the regulations were criticized for providing insufficient guidance for applying them.\textsuperscript{117} The IRS therefore often found it necessary to improvise valuation regimes, often loosely following valuation methods prescribed for transfers of tangible property.\textsuperscript{118}

Despite the lack of specific guidelines, the Tax Court has consistently established several submethods of transfer price allocation under the fourth method.\textsuperscript{119} The most commonly used submethods are profit split, rate of return, and income to expense ratios.\textsuperscript{120} Of these procedures, the most commonly used is the profit split method, which simply divides the total profits attributable to the

\textsuperscript{116} Id. § 1.482-2(d)(2)(iii)(a)-(m). These categories were:
(a) The prevailing rates in the same industry or for similar property,
(b) The offers of competing transferors or the bids of competing transferees,
(c) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted,
(d) The uniqueness of the property and the period for which it is likely to remain unique,
(e) The degree and duration of protection afforded to the property under the laws of the relevant countries,
(f) Value of services rendered by the transferor to the transferee in connection with the transfer . . . ,
(g) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,
(h) The capital investment and starting up expenses required of the transferee, . . . 
(j) The availability of substitutes for the property transferred,
(k) The arm’s length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,
(l) The costs incurred by the transferor in developing the property, and
(m) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm’s length consideration for the property.

\textit{Id.}

The new regulations provide considerably more sophisticated guidelines for establishing comparability of transactions for both tangible and intangible property. Under the new rules, comparability is determined by comparative analysis of functions, risks, contractual terms, economic conditions, and the property or services involved in the compared transactions. Temp. Treas. Reg. § 1.482-1T(c), 58 Fed. Reg. 5263, 5273-75 (1993); see infra notes 238-46 and accompanying text (examining revised standards of comparability).

\textsuperscript{117} See White Paper, supra note 59, at 460 (arguing that old regulations provided insufficient guidance because relative importance of each of twelve factors was unclear).

\textsuperscript{118} See White Paper, supra note 59, at 463 (discussing international examiners’ difficulty in allocating income attributable to transfers of intangibles). In fact, in approximately 40% of the cases involving intangibles that were surveyed in preparing the White Paper, international examiners reported inability to value intangibles under existing regulations and therefore resorted to different valuation methods. White Paper, supra note 59, at 466 n.53.

\textsuperscript{119} See White Paper, supra note 59, at 469-71 (discussing and analyzing cases in which Tax Court used differing fourth method approaches).

\textsuperscript{120} See White Paper, supra note 59, at 469-71 (discussing use of methods in cases involving sales of tangible property, transfers of intangibles, and provision of services).
controlled transactions at issue among the related parties.\textsuperscript{121} The validity of a court's final determination therefore rests on the accurate determination of actual profits and the reasonableness of the factors the court uses to divide profits among related parties.\textsuperscript{122} The factors used to obtain this profit split ratio ordinarily include each party's functions in the overall transaction, the property contributed by each party, and the risks undertaken by each party.\textsuperscript{123}

Unlike the three formal methods set forth by the regulations, however, the fourth method permits application of whatever means of analysis a court deems proper under the circumstances.\textsuperscript{124} In spite of the growing reliance on the profit split approach,\textsuperscript{125} some courts apply different methods, such as a rate of return approach or an analysis of income to expense ratios.\textsuperscript{126} In discussing the approaches available under the fourth method, the IRS has noted that although rate of return and income to expense ratios may provide a reasonable basis for determining transfer prices, courts have yet to develop these methods as a means to fill the analytic holes left by the § 482 regulations in cases where it is impossible to locate comparable uncontrolled transactions.\textsuperscript{127} An IRS study performed in preparation for promulgating regulations under the revised § 482\textsuperscript{128} therefore recommended that the profit split approach or a newly developed method should make clear the most prominent gray areas that fourth method analyses address.\textsuperscript{129}

\textsuperscript{121} See White Paper, supra note 59, at 469-70 (defining profit split method and acknowledging courts' frequent use of method).

\textsuperscript{122} White Paper, supra note 59, at 469.

\textsuperscript{123} White Paper, supra note 59, at 469. For example, Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988), involved transfers of highly valuable manufacturing intangibles, including patents and technical assistance, from a pharmaceutical company to a manufacturing subsidiary located in Puerto Rico in consideration of a single transfer of the subsidiary's stock. \textit{Eli Lilly}, 84 T.C. at 1002-27. In allocating significant profits back to the parent, the Tax Court pointed out, among other things, that a transfer of the type undertaken by the pharmaceutical company ordinarily would be made in consideration of a continuing income stream or periodic royalty rather than a single lump sum. \textit{Id.} at 1147-53.


\textsuperscript{125} See White Paper, supra note 59, at 469 (observing that profit split is most frequently used fourth method approach); see also Prop. Treas. Reg. § 1.482-6T, 58 Fed. Reg. at 5313-16 (proposing detailed profit split methodology and giving IRS authority to apply profit split provisions in determining arm's length results).

\textsuperscript{126} See White Paper, supra note 59, at 470 (discussing judicial application of rate of return and income to expense ratios in courts that choose not to use profit split). The rate of return approach compares a company's return on capital to that of other companies to show comparisons to the industry as a whole. \textit{Id.} Income to expense ratios compare gross income to total operating costs. \textit{Id.}

\textsuperscript{127} White Paper, supra note 59, at 471.

\textsuperscript{128} White Paper, supra note 59, at 458.

\textsuperscript{129} White Paper, supra note 59, at 471. The White Paper noted, however, that the courts "generally have failed to adopt a consistent and predictable methodology," and recom-
II. THE EVOLUTION OF TRANSFER PRICING METHODS UNDER THE TAX REFORM ACT OF 1986

In 1986, Congress recognized problems that the IRS faced in applying and enforcing the arm's length standard. Congress articulated growing perceptions that corporations were avoiding taxes in spite of the existing transfer pricing rules. In enacting the Tax Reform Act of 1986, Congress amended the essential articulation of U.S. transfer pricing policy: Internal Revenue Code § 482.

Prior to its amendment, § 482 did not address the particularly troublesome question of intangible property. Intangible property generally comprises a broad range of items such as patents, processes, or other proprietary information. The dilemma associated with placing a dollar value on transfers of intangible property mirrors the problems implicit in applying the international arm's length standard. While related parties often trade in goods and other tangible items of a highly proprietary nature, which therefore are difficult to price, they may also undertake patent assignments, licensing agreements, or outright sales of intangibles, the value of which may be measured only after the transferee has derived income.
from them.\textsuperscript{137}

For example, a U.S. corporation may spend a great deal of capital to develop a new product, realizing in the process a substantial tax deduction for its research and development costs.\textsuperscript{138} If the corporation then earns significant income by transferring the new technology to a foreign subsidiary that manufactures and markets the product, the problem becomes one of determining how much profit the transferred property will generate.\textsuperscript{139} The 1986 amendment to \$ 482 addressed this difficult question by providing that the transfer price or royalty attributable to the transferred intangible must be commensurate with the income generated through the intangible property's use.\textsuperscript{140}

This "commensurate with income" standard or "super royalty"\textsuperscript{141} represents a novel approach to transfer pricing. Although many have criticized the commensurate with income standard for its apparent deviation from the arm's length paradigm,\textsuperscript{142} the new stan-

\textsuperscript{137} See Williams, \textit{supra} note 35, at 1-2 (arguing that because information flow is not containable, value of intangible property is also not containable and recognizing that such value is hard to state until after transfer). The IRS has encountered this problem and has concluded that, at least for certain types of intangibles such as those with high profit potential, comparable transactions between unrelated parties (the basis for arm's length analysis) "almost never exist." White Paper, \textit{supra} note 59, at 479.

\textsuperscript{138} See 26 U.S.C.A. \$ 174(a) (West Supp. 1992) (permitting tax deduction for research and development expenses that are incurred in connection with trade or business).

\textsuperscript{139} Cf. White Paper, \textit{supra} note 59, at 463-64 (stating that only estimates can be made using various pricing methods for transfer of property).

\textsuperscript{140} I.R.C. \$ 482 (1988). As amended, \$ 482 states:

In the case of any two or more organizations, 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 Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he [or she] determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. \textit{In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.}

\textit{Id.} (emphasis added).

\textsuperscript{141} See Kaplan, \textit{supra} note 4, at 314 (discussing origins of term "super royalty" as payments "greater than industry averages or other commercial standards"); \textit{see also Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 1015 (Joint Comm. Print 1987) [hereinafter General Explanation] (stating that Congress meant to eliminate assumptions that industry norms or superficially appropriate royalties would insulate controlled taxpayers from scrutiny under \$ 482); Nathan Boidman, \textit{Revenue Canada's Transfer Pricing Circular: Selected Commentary}, 36 Can. Tax J. 405, 417 (1988) (stating that radical "super royalty" rule is intended to close avoidance loopholes).

\textsuperscript{142} See, e.g., Boidman, \textit{supra} note 141, at 417 (arguing that commensurate with income standard diverges from arm's length standard "because it disregards licenses entered into by a U.S. corporation at arm's length prices"); Emil Sunley et al., \textit{United States Section 482 White Paper, in Transfer Pricing for Intangibles: A Commentary on the White Paper 3, 4} (Fred C. de Hosson ed., 1989) (disagreeing with IRS's position that commensurate with income standard is in accordance with arm's length principles).
standard addresses the transfer pricing problem more directly than does the arm's length standard. Whereas the arm's length standard seeks to correct deviations in income distribution by adjusting prices on an after-the-fact, case-by-case basis, the commensurate with income standard goes to the root issue of transfer pricing by assessing the origins of corporate income and attempting to allocate to the correct party the end results of related-party transfers.

The amendment to § 482, however, did more than apply a transfer pricing standard that required consideration for transfers of intangibles to be commensurate with the income attributable to those intangibles. The Tax Reform Act's legislative history acknowledged that the then-existing regulations neither prescribed a means for pricing transfers of intangibles nor provided adequate means for pricing all transfers of tangible property. The legislative history recognized not only that many transactions do not compare objectively with transactions between unrelated parties, but also that some transactions between related entities simply cannot compare to transactions between unrelated parties. The amendment

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143. See 1979 OECD Report, supra note 16, at 13 (suggesting that adjustment procedures require analysis of particular circumstances with direct reference to specific facts of each transaction); see also General Explanation, supra note 141, at 1011 (explaining that regulations look to comparable transaction by same transferor of same or similar property).

144. See General Explanation, supra note 141, at 1015-17 (explaining that commensurate with income standard analyzes origin of corporate income and end results of transfers as means to avoid complicated task of adjusting prices over time to reflect changes in profitability).

145. See 57 Fed. Reg. 3571, 3572 (1992) (comments to proposed regulations) (noting deficiencies in regulations under § 482 concerning transfers of tangible property and proposing that closely related transactions be viewed together in determining arm's length).

146. See H.R. Rep. No. 426, supra note 42, at 423 (stating that allocation of income to transferor of intangibles does not assure adequate tax allocation under current regulations). The Committee on Ways and Means noted:

There is a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers can result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.

Id.

147. See H.R. Rep. No. 426, supra note 42, at 423-24 (recognizing general difficulty in obtaining comparable transactions); see also White Paper, supra note 59, at 464-65 (recommending additional measures to facilitate tangible property valuation in light of shortcomings of existing valuation methods).


149. See H.R. Rep. No. 426, supra note 42, at 423 (stating that regulations are not at fault, but suggesting that they are misdirected and pointing out that related-party dealings are fundamentally different from transactions between unrelated parties). Comparison problems arise because affiliated members of a multinational entity operate as individual economic units, rather than as competitors. Id. Furthermore, related parties do not face the same risk in transferring proprietary property to a related party as they would if dealing with an unrelated party. Id.
therefore sought to codify existing fourth method analyses with regard to transfers of tangible as well as intangible property.¹⁵⁰

A. The Commensurate with Income Standard

Although the single-sentence addition to § 482 did not significantly alter Treasury’s authority under the section, the amendment’s history does appear to alter Treasury’s responsibilities and offer some significant suggestions as to appropriate regulatory measures.¹⁵¹ For example, the House Ways and Means Committee recommended that licensing agreements for intangibles be subject to a retrospective review for purposes of maintaining arm’s length royalty rates.¹⁵² In addition, the conference committee suggested that the IRS carry out a comprehensive study of transfer pricing rules to determine whether then-existing regulations could be improved.¹⁵³

B. The IRS White Paper and the Basic Arm’s Length Return Method

On October 18, 1988, the IRS responded to the conference committee’s charge by issuing a comprehensive study of transfer pricing.¹⁵⁴ This study, known as the White Paper, was described as a preliminary “discussion draft,” intended to elicit commentary from interested parties.¹⁵⁵ Although the White Paper originally proposed a standard comment period, the volume of generally negative com-

¹⁵⁰ See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-637 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4725 (explaining that “conferees concluded that it would be appropriate for these principles to apply to transfers between related parties generally if income must otherwise be taken into account”).

¹⁵¹ See id. (suggesting that Treasury use innovations in allocating income attributable to intangibles to develop new methods for allocating income attributable to tangible property). The conference committee’s suggestion is similar to the congressional suggestion that led to the 1968 amendments to the transfer pricing regulations. See supra note 64 and accompanying text (discussing legislative history underlying 1968 amendments to Treasury regulations).

¹⁵² H.R. Rep. No. 426, supra note 42, at 424-25. The committee recognized that when related companies set royalty rates based on industry norms, the income realized from intangibles may be much higher than the agreed-to royalties reflect. Id. The committee therefore recommended a commensurate with income standard, which implicitly permits the IRS to address the correlation between royalties charged and income earned from previous tax years. Id. This approach has been subjected to harsh criticism. For example, Nathan Boidman argues that the commensurate with income standard diverges from the arm’s length standard because it disregards licenses entered into by a US corporation at arm’s-length prices. Instead, an appraisal or reassessment of the income must be taken into account by or imputed to the US transferor of the intangibles annually, and this amount must be “commensurate with the income attributable to the intangible.” Boidman, supra note 141, at 417.


¹⁵⁴ See White Paper, supra note 59, at 456-500 (outlining problems and suggesting solutions to transfer pricing problems); see also Kaplan, supra note 4, at 315 (explaining necessity for White Paper study to solve problems such as double taxation on intangible property transfers).

¹⁵⁵ See White Paper, supra note 59, at 453 (soliciting comments); Kaplan, supra note 4, at 315 (describing Treasury’s problem-solving approach in White Paper).
ments received forced Treasury to extend the comment period indefinitely and to postpone issuing its proposed and working regulations until 1992 and 1993, respectively.

1. The White Paper's interpretation of the commensurate with income standard

In discussing the application of the commensurate with income standard, the authors of the White Paper distinguished between "normal profit intangibles" and "high profit intangibles." The authors reasoned that comparable uncontrolled transactions are more likely to exist where a transferred intangible is not likely to produce an unusually high profit. The problem with allocating royalties after the fact is that such royalties will likely be so high as to appear to violate the arm's length rule. While an apparently inordinate "super royalty" might cause no problems for the tax authority imposing it, such a policy might concern the country to which the intangible is transferred, thereby leading to double taxation of the income attributable to that intangible.

The authors of the White Paper nonetheless stressed that their goal was not to create international tax conflicts. Rather, they made clear their understanding that "for certain classes of in-

156. See, e.g., Dr. Christoph Bellstedt, A German Tax Practitioner's View on the White Paper, in TRANSFER PRICING FOR INTANGIBLES: A COMMENTARY ON THE WHITE PAPER 66, 66 (Fred C. de Hosson ed., 1989) (disagreeing with White Paper proposals because IRS's assumptions concerning corporate decisionmaking and "clarity" of § 482 are false); Howard S. Engle, INTERNATIONAL DEVELOPMENTS: SECTION 482 WHITE PAPER—COMMENTS TO TREASURY, 16 J. CORP. TAX'N 386, 386-87 (1990) (summarizing comments that policy suggested by White Paper is overbroad, departs from international standards, and is impracticable in many situations).


158. See White Paper, supra note 59, at 472-75 (noting differences in applying commensurate with income standards to normal high-profit intangible).

159. White Paper, supra note 59, at 473.

160. See White Paper, supra note 59, at 473 (noting that royalty charged for transfer of highly valuable intangible to unrelated party may not have similar value as third-party license for normal intangible).


162. See id. at 322 (arguing that approach that imputes royalties is likely to cause international taxation problems, including double taxation). For example, German authorities have suggested:

An approach which "forbids," as it were, charging a straightforward sales price and instead imputes royalty payments (the amount of which is determined using the benefit of hindsight) is likely to cause substantial problems in the international context, in particular for straight-across transfers between high-tax jurisdictions.

Id.

tangibles (notably high profit potential intangibles for which comparables do not exist), the use of inappropriate comparables has failed to produce results consistent with the arm's length standard." 164 Thus, the commensurate with income standard does not conflict with the international arm's length standard, but merely represents an arguably better means to determine an arm's length price. 165

a. Functional analysis of profit components

The existing international commentary on the arm's length standard embodied in the OECD and U.N. Model Conventions does not avoid reference to profitability as a possible measure of arm's length value. 166 The OECD generally sanctions the application of some type of functional analysis that looks not only to the specific transaction at issue, but also to the whole relationship between transferor and transferee with regard to the transferred property. 167 The White Paper, on the other hand, proposed to determine transfer prices by a series of methods that would parallel those available under the then-existing regulations. 168 These methods were the exact and inexact comparable methods, 169 the basic arm's length return method (BALRM), 170 and BALRM with profit split. 171

The methods proposed in the White Paper are based on an interpretation of the commensurate with income standard that anticipates analysis of all aspects of the transferor/transferee relationship

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165. Cf. White Paper, supra note 59, at 475 (finding overwhelming evidence that arm's length is international norm and noting that implementation of valuation method that violates principles of arm's length would invite international disputes over tax jurisdiction).
166. See, e.g., 1979 OECD REPORT, supra note 16, at 17 (discussing relevance of functional analysis of profit); see also White Paper, supra note 59, at 476 (noting OECD's support for deriving arm's length price from functional analysis of related parties' overall operations, including profits).
167. See 1979 OECD REPORT, supra note 16, at 17 (explaining that tax authorities should take broad view of transaction and parties in assessing profit). The 1979 OECD Report states:
   Some familiarity with the structure and organisation of the group and some knowledge of which entities undertake the risks and responsibilities for the various activities are essential for tax authorities to help them in assessing when a profit is likely to arise and roughly what sort of profit it is likely to be.
Id.
168. See supra notes 76-108 and accompanying text (discussing comparable uncontrolled transaction, resale price, and cost plus methods).
169. See White Paper, supra note 59, at 485-88 (discussing role of "exact" and "inexact" comparables).
170. See White Paper, supra note 59, at 488-90 (describing use and application of BALRM).
171. See White Paper, supra note 59, at 490-91 (describing profit split addition to BALRM to be used when BALRM alone is unsatisfactory).
that contribute to profit. These aspects include the actual income derived from a transferred intangible, a functional analysis of the related parties' activities in exploiting the intangible, and the allocation of costs and risks between the related parties. In addition, the commensurate with income standard applies to all transfers of intangible property regardless of the nature of the intangible, the amount of income derived from the intangible, or the existence of similar transfers among unrelated entities.

b. Periodic adjustment of pricing allocations

The most troublesome feature of the White Paper's evaluation of the commensurate with income standard is its view that allocation of income attributable to intangibles may be retrospective, involving review and alteration of royalties that appeared to be arm's length in previous tax years. In cases involving long-term licensing agreements, for example, the standard "requires that intangible income be redetermined and reallocated" and that the costs and risks involved in the related parties' activities be reassessed periodically. In the case of a license, periodic adjustments could be required if there were substantial changes in factors such as the income attribu-

172. See White Paper, supra note 59, at 474 (concluding that functional analysis of all aspects of income is required to determine appropriate tax).

173. White Paper, supra note 59, at 474; see Elizabeth King, The Section 482 White Paper and the Proposed Regulations: A Comparison of Key Provisions, 4 TAX NOTES INT'L 331, 332 (1992) (observing that White Paper requires analysis based on actual rather than projected income and stating that this income should be allocated to real economic contributions by each party).

174. White Paper, supra note 59, at 474. This is not to say, however, that the commensurate with income standard completely eviscerates the comparable uncontrolled transaction method. In fact, the White Paper points out that if comparables exist, intangible income must be allocated on that basis. Id.; see King, supra note 173, at 332 (asserting that commensurate with income standard applies to all transfers of intangibles).

175. See White Paper, supra note 59, at 474 (suggesting periodic reevaluation of income attributable to intangibles to account for substantial changes); see also Watson, supra note 26, at 78 (discussing periodic reallocation of income under commensurate with income standard).

176. See White Paper, supra note 59, at 474 (concluding that changes in economic costs and risks may require altering initial royalty allocation); see also Sunley et al., supra note 142, at 4 (arguing that House Ways and Means Report indicates almost no regard for arm's length standard and that no international authority supports making periodic adjustments as under super royalty rule). The greatest negative effect of this rule may be that other tax jurisdictions would not recognize the validity of periodic adjustments, thereby causing instances of double taxation. See Sunley et al., supra note 142, at 4 (suggesting that proposed methodology is departure from international norms and would result in double taxation and enormous administrative burdens on taxpayers); see also Guenter Schindler & David Henderson, IRS White Paper Revisits Section 482, in TRANSFER PRICING FOR INTANGIBLES: A COMMENTARY ON THE WHITE PAPER 14, 18 (Fred C. de Hosson ed., 1989) (suggesting that White Paper provisions may shift income to United States, thereby unduly benefiting United States while not significantly decreasing foreign taxes paid by company).

177. White Paper, supra note 59, at 474.

178. White Paper, supra note 59, at 474; see H.R. CONF. REP. No. 841, supra note 150, at II-637-38, reprinted in 1986 U.S.C.C.A.N. at 4725 (stating that continuing transfers such as licensing agreements should be subject to review to determine royalty's adequacy).
table to the intangible, the relative economic activities performed by the related parties, or the assets employed by the licensee.\footnote{179}

On its face, the periodic adjustment provision appears to depart from the arm's length standard because it permits the calculation of an appropriate royalty to go forward after information regarding profits realized on a transfer has become available.\footnote{180} Nonetheless, unrelated parties ordinarily do not enter into licensing agreements, particularly agreements involving high-profit intangibles, without including some means of adjusting royalties if actual profitability were greater or less than expected.\footnote{181} Despite its superficial conflict with the arm's length standard, periodic review would actually incorporate the spirit of the arm's length standard by permitting a tax authority to set transfer prices by the same means as would unrelated parties, who might be inclined to enter into a royalty agreement that permitted periodic rate adjustments.\footnote{182}

2. The basic arm's length return method

The centerpiece of the White Paper's proposals is the functional analysis involved in the BALRM.\footnote{183} As its name suggests, the BALRM seeks to determine the return on investment that unrelated parties might expect if they engaged in the same transaction by attributing income to each related member of a multinational group.\footnote{184} The BALRM identifies the contributions, including "assets and other factors of production," of each member of a group

\footnote{179. White Paper, \textit{supra} note 59, at 478; see King, \textit{supra} note 173, at 332-33 (describing White Paper's suggestion of periodic adjustment requirement). The White Paper suggested that guidelines for determining whether to subject a taxpayer to periodic review should include:

\begin{itemize}
  \item[(a)] the size and number of markets penetrated;
  \item[(b)] the product's market share;
  \item[(c)] the product's sales volume;
  \item[(d)] the product's sales revenue;
  \item[(e)] the number of uses for the technology;
  \item[(f)] improvements to the technology;
  \item[(g)] marketing expense;
  \item[(h)] production costs;
  \item[(i)] the services provided by each party in connection with the use of the intangible; and
  \item[(j)] the product's profit margin or the process' cost savings.
\end{itemize}


\footnote{180. See Watson, \textit{supra} note 26, at 77-78 (noting that mandatory readjustment of royalty rates may conflict with arm's length standard).

\footnote{181. See White Paper, \textit{supra} note 59, at 479, 486-87 (implying that unrelated-party transfers rarely involve high-profit intangibles that would require periodic review).


\footnote{183. See White Paper, \textit{supra} note 59, at 488-91 (describing basic arm's length method, or BALRM, and its applicability to exact and inexact comparables).

\footnote{184. See White Paper, \textit{supra} note 59, at 488-89 (providing goal of BALRM and explaining its applicability); see also King, \textit{supra} note 173, at 335-36 (summarizing income attribution function of BALRM).}
and allocates each party's income by comparing those contributions to the income earned by the enterprise as a whole.185

The transfer scheme to which the BALRM applies corresponds closely to the third hypothetical discussed previously.186 In a situation where a related foreign licensee takes only the intangible property but contributes all raw materials, labor, and technical know-how to manufacture a finished product, the value of the transferred intangible property is not reflected directly by the sale price of the

185. White Paper, supra note 59, at 488-89. See generally Kaplan, supra note 4, at 316-17 (illustrating application of BALRM to hypothetical transfer between U.S. parent and marketing subsidiary located in tax haven jurisdiction). As this description suggests, the BALRM is an "input-based" methodology. See King, supra note 173, at 335 (contrasting BALRM, which analyzes component parts contributing to realized profit, with traditional "output" methodologies, which compare taxpayer's stated income with income imputed from similar transactions by unrelated parties). Although the arm's length standard generally invites analysis based on output, both the BALRM and traditional methodologies rely on comparables and reach the same result. See id. at 335 (stating that input-based and output-based methodologies should yield similar results). The BALRM therefore does not differ substantially from the traditional arm's length methodology. See White Paper, supra note 59, at 475-77 (reasoning that traditional arm's length analysis and BALRM both anticipate individual calculation of earnings by each related group member); George N. Carlson et al., The Section 482 White Paper: Highlights and Implications, or How Economists Stopped Feeling Inferior to Tax Lawyers and Learned To Love Tax Reform, 41 TAX NOTES 547, 548 (1988) (observing similarity between BALRM and arm's length standard and stating that by using BALRM, "White Paper reaffirms the arm's length principle as the cornerstone of U.S. intercompany pricing rules"). But see Engle, supra note 156, at 390-91 (characterizing BALRM as unworkable under certain conditions such as when intangibles are used to produce more than one product); Sunley et al., supra note 142, at 4 (stating that BALRM diverges from international standard, particularly in application of periodic adjustments); see also Boidman, supra note 141, at 417 (criticizing commensurate with income basis for disregarding licenses entered into at arm's length prices in favor of comprehensive analysis).

One criticism of the BALRM is that its use rules out, in all situations in which specific comparables are lacking, the use of equally effective methods such as profit split. See Kaplan, supra note 4, at 318 (criticizing reliance on BALRM as principal, rather than default method). Other criticisms provide that the BALRM generally ignores the crucial element of risk assumption, see Jon E. Bischel, White Paper Analysis: Ballroom Dancing with an Intangible, 41 TAX NOTES 1097, 1098 (1988) (noting that Treasury did not address risk assumption in White Paper), and that BALRM's record-keeping requirements would impose an administrative nightmare on taxpayers, even where necessary information was available. See 57 Fed. Reg. 3571, 3572 (1992) (comments to proposed regulations) (citing comments asserting that information required by BALRM might not always be available); Sunley et al., supra note 142, at 4 (noting that taxpayers' failure to keep adequate documentation presents administrative problem). A final criticism is that the BALRM misses the essential purpose of transfer pricing, which is to allocate income among geographic tax jurisdictions rather than among related entities. See Wickham & Kerester, supra note 13, at 342-43 (making clear that no requirement exists that reallocation powers be consistent with international division of taxes). The BALRM, Wickham and Kerester contend, merely carries on the problems implicit in the old regulations. Id. at 342-43. They further state:

The end result is a system strong in preserving and encouraging the power of the country to reallocate tax attributes in ways that will protect and increase its revenues but very weak and lacking in mandates to consider revenue interests and tax claims of other countries based on the source of the income. Id. at 343; see also 57 Fed. Reg. at 3572 (admitting that BALRM would most likely allocate income disproportionately to U.S. entities).

186. See supra notes 52-58 and accompanying text (summarizing typical "round-trip" transfer of intangible property).
finished product. Furthermore, comparable uncontrolled transactions may not be adequate to value the intangible in this type of situation.

Thus, the BALRM first applies a functional analysis that separates into their component functions all aspects of the related businesses that the intangible transfer affects. Next, the method assigns a value to each function performed by the affiliate to which the intangible was transferred. After the returns attributable to each of the affiliate's functions have been calculated, the residual income, or income attributable solely to the intangible property, is allocated to the parent.

Despite the BALRM's apparent departure from a standard search for comparable uncontrolled transfers, the departure is largely superficial. Whereas traditional arm's length analysis seeks uncontrolled dealings involving transactions similar to the transfer at issue, the BALRM's "breakdown" methodology continues to use comparable transaction information to determine the relative effect of each part of a transaction on the profitability of the transaction as a whole. Because any methodology employed under the BALRM must rely implicitly on arm's length information, the BALRM can-

187. See White Paper, supra note 59, at 488 (discussing difficulties inherent in pricing transactions where intangible property is mere component of finished product).
188. See White Paper, supra note 59, at 488-89 (highlighting limitations of traditional analysis and explaining how process of comparing similar transactions can be inadequate basis on which to price intangibles).
190. White Paper, supra note 59, at 489. The rationale underlying this process is that each discrete function carried on by an affiliate in employing the intangible may be measured and valued using standard factors. Id.
192. See White Paper, supra note 59, at 476 (asserting that arm's length standard implies BALRM or similar functional analysis and fits in with periodic adjustments); Watson, supra note 26, at 78 (arguing that limited periodic reviews under BALRM methodology would still conform to arm's length).
193. See White Paper, supra note 59, at 476 (arguing that traditional arm's length analysis as espoused by OECD is not inconsistent with functional analysis because both analyses ultimately utilize similar means to determine likely profits). The White Paper suggests two methods for incorporating comparable arm's length data into the BALRM equation. The first method examines unrelated parties' assets and contributions to ultimate income, calculates appropriate rates of return for each function based on similar functions carried on by unrelated parties, and applies the expected rate of return to each party's assets. Id. at 489. The second method, which is useful when "assets are difficult to measure consistently, or . . . 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," computes the ratio of gross income to operating costs for the foreign affiliate and compares the ratio to corresponding ratios of unrelated parties engaged in similar operations. Id. This second method, commonly referred to as a "Berry ratio," see id. (discussing method's use by Dr. Charles Berry to calculate returns on service activities, among other things), provided the basis for the rate of return determination in E.I. Du Pont de Nemours & Co. v. United States, 608 F.2d 445, 449-56 (Ct. Cl. 1979), where the court used Berry's computed ratio to determine gross income before reducing operating and interest costs.
not help but satisfy the spirit of the arm's length standard.\textsuperscript{194} The BALRM indicates, however, that traditional application of the arm's length standard has limits, especially where certain transactions are so unique to the parties involved that they would not occur between unrelated parties.\textsuperscript{195} The type of functional analysis proposed by the BALRM appears to be within the OECD's proposed methods for determining an arm's length price.\textsuperscript{196} Indeed, a functional analysis is practically mandatory to attribute proper royalties to transfers of particularly valuable intangibles when even prices charged between unrelated parties may not adequately reflect all arm's length considerations.\textsuperscript{197}

C. The Emerging Regulatory Framework

1. The proposed regulations

Early commentary on the White Paper was generally critical of the IRS proposals, particularly the perceived overreliance on the BALRM.\textsuperscript{198} In January 1992,\textsuperscript{199} the U.S. Treasury responded by proposing regulations that would replace the BALRM with a comparable profit valuation method.\textsuperscript{200} This new method coordinated its functional analysis by means of a "comparable profit interval" (CPI), or index of acceptable profit ranges derived from functionally comparable profit indicators observable in uncontrolled transactions.\textsuperscript{201}

\textsuperscript{194} See White Paper, supra note 59, at 488 (arguing that because BALRM determines final arm's length price attributable to given transaction by analyzing each part of operation involved with intangible, BALRM employs comparable information available from dealings among unrelated parties). The primary difference between the BALRM and traditional methods, therefore, is the scope of the requisite inquiry.

\textsuperscript{195} See White Paper, supra note 59, at 473 (observing that unrelated parties rarely transact in highly valuable intangible property).

\textsuperscript{196} See 1979 OECD REPORT, supra note 16, at 17 (suggesting that tax authorities apply functional analysis to determine arm's length prices). But see Sunley et al., supra note 142, at 6 (asserting that no international authority, including OECD, supports periodic adjustments).

\textsuperscript{197} See White Paper, supra note 59, at 473 (describing need for independent analysis of high-profit intangibles because high royalty rates are rarely arm's length). Unrelated parties involved in a transfer or license of intellectual property may themselves be hard pressed to set a royalty rate that they find appropriate. Just what constitutes a royalty that will provide a fair rate of return for intellectual property is the subject of some debate. See generally Russell L. Parr, Insights into Royalty Rate Economics, 15 Les Nouvelles 95, 96-97 (1990) (asserting that methods commonly used to establish royalty rates fail to account adequately for rates of return on investment).


\textsuperscript{199} See id. at 3571-3601 (publishing and explaining proposed regulations).

\textsuperscript{200} See id. at 3574 (describing comparable profit interval method and explaining steps and reasons for proposed changes).

\textsuperscript{201} See id. (relating mathematical comparable profit interval to uncontrolled party analysis).
Although the proposed regulations offered a reliable method for constructing transfer prices, they did so only with great complexity.\textsuperscript{202} Despite the presence of fairly orthodox methods based on comparable transactions,\textsuperscript{203} the proposals also prescribed a strict priority of application,\textsuperscript{204} which itself drew negative criticism.\textsuperscript{205} Moreover, the proposals’ functional analysis centerpiece, CPI, was intended not only to determine appropriate prices under the comparable profit method,\textsuperscript{206} but also to provide a check on the adequacy of adjustments made under the comparable adjustable transaction method.\textsuperscript{207}

In fact, merely assembling a CPI is a complex operation requiring careful planning and accounting by a taxpayer who uses the method. Construction of the CPI for any given transaction requires six steps: (1) selecting the controlled entity to be tested (usually the transferee);\textsuperscript{208} (2) determining appropriate business classifications associated with the transferred intangible and developing a sample of unrelated entities that engage in similar operations;\textsuperscript{209} (3) computing “constructive operating incomes” derived from an application of profit indicators, such as return ratios or profit splits, to the tested party’s attributes such as assets and costs;\textsuperscript{210} (4) computing an appropriate CPI by isolating the most uniform unrelated-party

\textsuperscript{202} See Steven P. Hannes, An Examination of the New U.S. Transfer Pricing Proposals, 3 TAX NOTES Int'l 281, 291 (1992) (projecting that proposed measures would impose great burdens of tax planning and information gathering on taxpayers).


\textsuperscript{204} See Prop. Treas. Reg. § 1.482-2(d)(2)(iii), 57 Fed. Reg. at 3580 (prescribing specific priority of application of different methods for determining arm’s length considerations).

\textsuperscript{205} See Helmut Becker, The Citizen and the Role of Taxation, 1992 INTERTAX 210, 210 (contending that priority system established by tax authority unduly shifts burden from tax examiner to taxpayer at expense of practical efficiency).

\textsuperscript{206} See Prop. Treas. Reg. § 1.482-2(d)(5)(i), 57 Fed. Reg. at 3583 (explaining that CPI would be used if no uncontrolled transfers meet matching or comparable adjustable standards).

\textsuperscript{207} See id. § 1.482-2(d)(4)(i), 57 Fed. Reg. at 3581-82 (explaining that potential comparable adjustable transaction would not satisfy requirements of method if result were not within CPI).

\textsuperscript{208} Id. § 1.482-2(f)(3)(i), 57 Fed. Reg. at 3587; see King, supra note 173, at 336 (describing process for designating test party).


data;\textsuperscript{211} (5) determining "the most appropriate point" in the CPI, if necessary;\textsuperscript{212} and (6) determining an appropriate transfer price based on the CPI.\textsuperscript{213} Nonetheless, to the extent that the CPI incorporates valuation methods that are already in informal use, such as profit split or rate of return analyses,\textsuperscript{214} and to the extent that it offers a reasonably objective means by which to price particularly difficult transactions,\textsuperscript{215} the CPI would appear to offer a measure of objective certainty unavailable under the old regulations. The CPI's reliance on data derived from unrelated-party dealings, while arguably minute in detail, is firmly grounded in the international standard of arm's length.\textsuperscript{216} As such, commentary on the proposed regulations criticized not so much the CPI as its predominance over more traditional methodologies.\textsuperscript{217}

2. The new regulations

Temporary regulations that became effective on April 21, 1993,\textsuperscript{218} respond to adverse criticism of the 1992 proposals by increasing the pricing rules' flexibility while simultaneously attempting to limit ambiguities that might have surfaced under the proposed regulations.\textsuperscript{219} The temporary regulations retain a vari-

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\textsuperscript{212} Prop. Treas. Reg. § 1.482-2(f)(3)(v), 57 Fed. Reg. at 3587; see King, supra note 173, at 337 (suggesting that taxpayer's relative parity with unrelated entities from which CPI is derived provides basis for placement on interval). Application of this step ordinarily is not required unless the consideration paid was manifestly disproportionate to the income realized. King, supra note 173, at 336.

\textsuperscript{213} Prop. Treas. Reg. § 1.482-2(f)(3)(vi), 57 Fed. Reg. at 3587; see King, supra note 173, at 337 (suggesting that any point within interval would be proper transfer price unless circumstances require otherwise).

\textsuperscript{214} See supra note 203 and accompanying text (explaining proposed regulations' utilization of orthodox valuation methods).

\textsuperscript{215} See 57 Fed. Reg. 3571, 3574 (1992) (comments to proposed regulations) (asserting that CPI would permit taxpayers "to apply objective measures of profitability . . . to their own financial data" and thereby confirm or correct reported transfer prices).

\textsuperscript{216} See 1979 OECD REPORT, supra note 16, at 17 (recommending functional analysis of unrelated parties in determining arm's length price). By reducing noncomparable transactions to their component parts, a tax examiner may apply more traditional analyses to ascertain values for each segment of the related-party transfer. See id. (stating importance of breaking down entities into functional segments in order to assess likely profits from transaction). Because the parts that compose the CPI are derived by standard arm's length methods, the method as a whole utilizes basic arm's length principles. See 57 Fed. Reg. at 3574 (issuing priority to methods that most accurately produce arm's length price).

\textsuperscript{217} See 58 Fed. Reg. 5263, 5265 (1993) (comments to temporary regulations) (noting that commenters disagreed with proposed use of CPI as both valuation method and check on other methods, but praised flexibility offered under CPI).

\textsuperscript{218} Id. at 5263.

\textsuperscript{219} See Temp. Treas. Reg. § 1.482-1T(a)(1), 58 Fed. Reg. 5263, 5272 (1993) (explaining that new rules were intended to reflect income more clearly than old regulations); id. § 1.482-1T(b)(2)(iii)(A), 58 Fed. Reg. at 5273 (increasing flexibility of rules by implementing choice of method provision); see also New Transfer Pricing Rules Seen Offering Flexibility, Requiring Added Docu-
ant of the comparable profits method that the proposed regulations advocated, however, and the apparent perceived congressional mandate for greater accuracy in determining transfer prices promises to manifest itself in heavier reporting burdens for taxpayers. Furthermore, preliminary international response has been tentative, with feedback ranging from praise for the new regulations’ return to a standard more in line with international norms, to fears that the regulations will impose rigid pricing margins that will discriminate among firms operating under different economic conditions. Some responses also reflect mistrust of the Clinton administration, which is perceived as being too zealous in its efforts to fulfill campaign promises for more aggressive enforcement of transfer pricing rules. Regardless of any adverse reaction, the temporary regulations will provide a clinical setting within which the § 482 amendment may be assessed.

The new regulations provide a total of eight valuation methods: five apply to transfers of tangible property and three apply to...
transfers of intangible property.\textsuperscript{227} Apart from the addition of the comparable profit method,\textsuperscript{228} the new regulations' valuation mechanisms do not differ radically from those of the old regulations.\textsuperscript{229} The essential differences between the old and new regulations are rooted in the procedural measures provided under temporary Treasury regulation § 1.482-1T.\textsuperscript{230} Specifically, the most significant changes lie in the adoption of a choice of method rule,\textsuperscript{231} detailed and flexible standards of comparability,\textsuperscript{232} and a "safe harbor" for small taxpayers.\textsuperscript{233} Although the reporting burdens necessary to prove comparability between given transactions may increase under the new regulations, the general effect of the regulations should benefit taxpayers by providing them with flexible means of justifying their reported income allocations while improving upon the accuracy and reliability of more traditional methods.

\textit{a. Choice of method}

In response to comments on the proposed regulations, the IRS acknowledged that problems exist with imposing a rigid hierarchy for applying valuation methods and therefore promulgated the

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"best method rule." The best method rule provides guidelines by which taxpayers may decide which valuation method will best meet the circumstances of the transaction under review. Rather than force a particular method into use in a given situation, the best method rule permits taxpayers to apply any available method that will allow them to obtain an accurate result. In general, however, the rule requires application of the method that will bring about the most accurate result under the circumstances.

b. Standards of comparability

The regulations that provide for determining relative comparability of controlled and uncontrolled transactions adhere to the principles of the arm's length standard. Because of the lack of comparable uncontrolled transactions in many circumstances, however, the new regulations permit the use of a comparable transaction that incorporates factors present in uncontrolled transactions if the comparable transaction corresponds to factors present in the transaction under review. Comparability is thus reviewed on the basis of functions, risks, contractual terms, economic conditions, and property or services involved in the controlled and uncontrolled transactions under comparison. By thus compiling a hypothetical comparable transaction from comparable components of uncontrolled transactions, the new standards of comparability avoid the problems inherent in comparing whole transactions. Where certain elements of controlled and uncontrolled transfers differ in some material respect, they may be adjusted in order to obtain a functional comparable transaction.

In addition, the comparability standards permit adjustment under special circumstances that would otherwise skew a taxpayer's actual

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236. *See id.* (permitting taxpayers to determine arm's length price using any method available without first demonstrating inapplicability of other methods).

237. *Id.*

238. *See id.* § 1.482-1T(c)(1)(i), 58 Fed. Reg. at 5273 ("The arm's length character of a controlled transaction is tested by comparing the results of uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.").

239. *Id.*

240. *Id.*

241. *See id.* § 1.482-1T(c)(2), 58 Fed. Reg. at 5274 (permitting reasonable adjustments to account for differences in relevant factors where such differences have clear and reasonably discernable effect on prices or profits).
income. For example, the regulation permits adjustments to compensate for a pricing strategy reasonably intended to enhance the taxpayer's market share, thus granting leeway for competitive strategies and market penetration efforts that might otherwise be penalized. Furthermore, despite some assertions to the contrary, the new regulations provide that comparable transactions should be obtained from the same geographic market in which the controlled transaction takes place, so as to permit adjustment for geographic variables such as costs and resale prices and to account for location savings.

c. Safe harbors

In response to comments advocating adoption of a "safe harbor," or rule permitting before-the-fact election of a strict formulaic means for determining taxable income, the new regulations permit certain taxpayers to elect a safe harbor in lieu of applying other valuation methods. To be eligible for the safe harbor, a taxpayer must be a U.S. entity earning less than $10 million in aggregate annual sales revenue or a U.S. entity that engages in controlled transactions with a foreign entity that earns less than $10 million in aggregate annual revenue. Eligible taxpayers that elect the safe harbor are insulated against potential income allocations by applying an "appropriate profit level indicator" to be provided in forthcoming revenue procedures.

Although the safe harbor provides a measure of certainty for smaller firms engaged in controlled transactions, the IRS was quick to note that the rigidity of the rules applied to determine income under the safe harbor may produce results less favorable than

242. Id. § 1.482-1T(c)(4)(i), 58 Fed. Reg. at 5275-76.
243. See, e.g., Slutsky, supra note 223, at 12 (suggesting that new regulations will penalize firms realizing location savings because of geographic differences in markets).
245. Id.
246. Id. § 1.482-1T(c)(4)(ii)(C), 58 Fed. Reg. at 5276.
247. See White Paper, supra note 59, at 481 (defining "safe harbors" as "mechanical, bright-line tests that may be used in lieu of the fact-specific arm's length inquiry under section 482"); see also 58 Fed. Reg. 5263, 5268 (1993) (comments to temporary regulations) (observing numerous requests for implementation of safe harbor provisions).
250. Id. § 1.482-1T(f)(1)(i), 58 Fed. Reg. at 5281.
what might be available under the general rules. Nevertheless, the safe harbor provides a positive means for determining appropriate transfer prices. Taxpayers electing the safe harbor will be able to predict precisely the documentation necessary for reporting income attributable to controlled transactions and may benefit from the highly simplified requirements for tax planning and accounting.

d. The comparable profits method

Despite criticism of the proposed regulations' heavy reliance on the CPI, the new regulations have carried a "comparable profits method" (CPM) into application as an alternative method for valuing controlled transfers of tangible and intangible property. In general, the comparable profits method operates on the principle that "similarly situated taxpayers will tend to earn similar returns over a reasonable period of time." Like the comparable profits method provided by the proposed regulations, the new regulation offers an index, or range of results, that will be deemed appropriate.

In general, the CPM compares a taxpayer's profits with a range of constructive operating profits derived from profit level indicators available from uncontrolled taxpayers. The method operates by first selecting a party to be tested, which ordinarily is the party to the controlled transaction that performs the simplest operations and which need not be the taxpayer under examination. The CPM then requires selection of comparable parties that bear profit level indicators similar to those of the tested party. The term "profit level indicators" generally means financial ratios that measure the relationships among profits, costs, and resources involved in the transactions in question. Appropriate profit level indicators in-

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252. See id. (observing that certain taxpayers may achieve less favorable results under safe harbor, while others may benefit).

253. See id. at 5265 (discussing commentators' criticism of proposed regulations' overreliance on CPI as check on results obtained under other methods).


256. See Temp. Treas. Reg. § 1.482-5T(d), 58 Fed. Reg. at 5290 (defining arm's length range as "range of constructive operating profits derived from comparable parties").


259. Id. § 1.482-5T(c), 58 Fed. Reg. at 5290. Because the method seeks to establish a range of acceptable results, the parties selected need not be strictly comparable, id., and adjustments to account for material differences between the profit level indicators of the tested and comparable parties may be relatively permissive. Id.

260. Id. § 1.482-5T(e), 58 Fed. Reg. at 5291.
clude rates of return on capital\(^1\) and financial ratios such as operating profit to sales or gross profits to operating expenses.\(^2\)

Once a taxpayer determines appropriate comparable profit level indicators, the final step is to determine the arm’s length range.\(^3\) Ordinarily, the range includes all of the constructive operating profits derived from the comparable parties.\(^4\) When a taxpayer references appropriate comparable transactions but does not adjust the transactions to account for material differences in profit level indicators, the arm’s length range generally will fall between the twenty-fifth and seventy-fifth percentiles of the constructive operating profits derived from the unadjusted profit level indicators.\(^5\)

It is important to note that the comparable profits method is offered only as an alternative; the method may not satisfy the requirements of all possible transactions.\(^6\) The new regulations maintain the taxpayer’s recourse to fourth method analysis, provided that adequate documentation exists and that the taxpayer makes appropriate disclosure to the IRS.\(^7\) Preserving the “other methods” analysis perhaps reflects some humility on the part of the IRS, which seems to acknowledge that the methods set forth in the proposed regulations will not satisfy the necessities of every circumstance.\(^8\)

3. A look forward

A hard look at the new regulations and the generally favorable response to them by tax practitioners\(^9\) suggests that the IRS has succeeded in its quest to establish a more accurate and reliable transfer pricing regime. After years of harsh commentary,\(^10\) the

\(^{261}\) Id. \(\S 1.482-5T(e)(1), 58\) Fed. Reg. at 5291.

\(^{262}\) Id. \(\S 1.482-5T(e)(2), 58\) Fed. Reg. at 5291.

\(^{263}\) See id. \(\S 1.482-5T(d)(1), 58\) Fed. Reg. at 5290 (setting forth provisions governing arm’s length range determination).

\(^{264}\) See id. \(\S 1.482-5T(d)(2)(i), 58\) Fed. Reg. at 5290 (providing that constructive operating profits will provide appropriate arm’s length range when appropriate comparability standards are met).

\(^{265}\) Id. \(\S 1.482-5T(d)(2)(ii), 58\) Fed. Reg. at 5290-91. This alternative range may be used only if four or more comparable parties contribute to the constructive operating profits. Id.

\(^{266}\) See id. \(\S 1.482-5T(a), 58\) Fed. Reg. at 5290 (describing circumstances under which CPM may be applied and noting that for purposes of best method rule, CPM may not yield accurate results in certain transactions involving valuable, nonroutine intangibles).

\(^{267}\) See id. \(\S\S 1.482-3T(e)(2), -4T(d)(2), 58\) Fed. Reg. at 5286-87, 5288 (providing conditions for use of other methods for transactions involving tangible and intangible property).

\(^{268}\) See 58 Fed. Reg. 5263, 5265, 5269 (1993) (comments to temporary regulations) (discussing criticism of valuation method’s rigidity and describing provision that permits use of other reasonable method where such method is more accurate).

\(^{269}\) See generally New Transfer Pricing Rules, supra note 219, at 1 (reporting general satisfaction with new regulations among tax practitioners).

\(^{270}\) See, e.g., Bellstedt, supra note 156, at 72 (positing that complexity of White Paper with regard to pricing intangibles raises question of whether IRS intends to discourage U.S. businesses from making foreign investments); Go Kawada, Comments on Section 482 White Paper, in
process that began with the issuance of the White Paper appears to be close to conclusion, and it seems to have addressed the bulk of prevailing concerns. Yet to be determined, however, is the extent to which the IRS has succeeded in carrying out the congressional mandate of the commensurate with income standard. To be sure, the CPM provides significantly more guidance than was available under the standard methodologies of comparable uncontrolled price, resale price, and cost plus; nevertheless, the regulations admit their own limits. At a minimum, however, the new rules represent a significant step forward. They offer a great deal of flexibility of application, and at the same time establish a fairly strict policy for applying individual valuation methods that promises a measure of reliability previously unavailable.

Regardless of the revolutionary measures invoked by the new regulations and regardless of their effectiveness in ascertaining arm's length prices, however, the proposals represent a unilateral statement of policy. To the extent that transfer pricing analysis under the new regulations may vastly clarify and help to control what continues to be perceived as a substantial revenue loss for the United States, the regulations will certainly aid in protecting the U.S. fisc. At the same time, however, the new measures may also cause more instances of double taxation, thereby burdening taxpayers and tax authorities in the United States and abroad. Without bilateral co-
operation, or at least acknowledgment of the validity of the new valuation regime, the United States and its trading partners will likely disagree over income allocations, thereby creating further potential instances of double taxation.277

Whether or not the measures included in the new regulations are implicitly or explicitly sanctioned by international interpretations of the arm's length standard, any abstract grant of permission to implement these measures is of little help if the measures conflict with the transfer pricing practices of trading partners.278 A transfer pricing adjustment that is disregarded by the tax authorities of a foreign affiliate creates not only double taxation problems for the taxpayer but also treaty problems for the countries involved.279

D. The Potential for Conflict with Foreign Tax Systems

From an international perspective, the problem with the new U.S. regulatory scheme may be that it is ahead of its time. For example, Canada, the largest U.S. trading partner,280 only recently adopted transfer pricing provisions that specifically apply the suggestions of the OECD.281 Similarly, Japan relies primarily on the comparable

277. See Japan Foreign Trade Council, supra note 276, at 1306 (reporting Japanese fear of resulting double taxation under new regulations and noting Japanese suggestion that new regulations should be implemented only after foreign states have entered into appropriate agreements).

278. See OECD Model Convention, supra note 12, art. 9, at 30 (suggesting that discrepancies between national transfer pricing policies may result in double taxation).

279. See OECD Model Convention, supra note 12, art. 9, at 30 (asserting that where one contracting state has made transfer pricing allocation, other shall make proper adjustment, and that disagreement with transfer pricing policy of partner to treaty therefore leads inescapably to difficulties under article 9 of OECD Model Convention).

280. See Paul S. Dempsey et al., Canadian Transport Liberalization: Planes, Trains, Trucks & Buses Rolling Across the Great White North, 19 TRANSP. L.J. 113, 179 (1990) (asserting that Canada and United States are each other's largest trading partner).


Canada's application of transfer pricing adjustments occurs only in the case of outbound non-arm's length transfers, or transfers in which a Canadian entity has either paid too much or received too little consideration for its transfer. See Income Tax Act, R.S.C., ch. 63, § 69(2) (1970-1972) (Can.) (permitting allocation when taxpayer in Canada has paid or agreed to pay to nonresident amount greater than that which would have been appropriate had transaction been at arm's length); id. § 69(3) (permitting allocation when nonresident has paid or agreed to pay to taxpayer reasonable arm's length amount even when nonresident has not dealt with taxpayer at arm's length).
uncontrolled price, cost plus, and resale price methods,\textsuperscript{282} resorting to other methods such as rate of return or profit split only where necessary.\textsuperscript{283} Finally, some foreign commentary on the White Paper asserted vehemently that unilateral adoption of such measures will effectively repudiate U.S. treaty obligations.\textsuperscript{284} More than any other, this fact indicates that conflict will most certainly occur under the new regulations. When treaty partners disagree over the "correct" interpretation of arm's length prices, double taxation is the most probable result.\textsuperscript{285}

III. RESOLVING INTERNATIONAL DISPUTES ARISING OVER TRANSFER PRICING ADJUSTMENTS

Notwithstanding any argument that the new regulations comply with the arm's length standard, international authorities have recognized problems inherent in unilateral application of such regulations.\textsuperscript{286} When double taxation occurs, it creates problems involving not only a single aggrieved taxpayer and its government, but also bilateral relations.\textsuperscript{287} To eliminate international double taxation conflicts, a taxpayer may either avoid double taxation by way of a prior understanding\textsuperscript{288} or correct the problem after it has occurred.\textsuperscript{289}

The first alternative, commonly referred to as a safe harbor, pro-

\begin{itemize}
\item \textsuperscript{282} See Kawada, supra note 270, at 62 (reporting that primary methods used by Japan are comparable uncontrolled price, cost plus, and resale price methods).
\item \textsuperscript{283} See Kawada, supra note 270, at 62 (suggesting that rate of return and profit split analyses should be used only as tools to check validity of adjustments made under one of primary methods, and asserting that "[i]t is dangerous to rely too much" on fourth methods). \textit{Id.}
\item \textsuperscript{284} See, e.g., Bellstedt, supra note 156, at 69 (asserting that BALRM and periodic adjustments are "another sad example for the preparedness of the United States to disregard international treaty obligations").
\item \textsuperscript{285} See OECD Model Convention, supra note 12, art. 25, at 42 (noting that double taxation may result from disagreements between countries on transfer pricing policies).
\item \textsuperscript{286} The OECD Committee on Fiscal Affairs points out: [T]he varied activities of any [multinational enterprise] and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. [Such methods'] unco-ordinated use by the tax authorities of several countries would involve the danger that, overall, the [multinational enterprise] affected would suffer double taxation of its profits.
\item \textsuperscript{1979 OECD REPORT, supra note 16, at 15.}
\item \textsuperscript{287} See OECD Model Convention, supra note 12, art. 25, at 42 (calling not only for relief for aggrieved taxpayer, but also for reconciliation of bilateral relations by requiring contracting states to endeavor to resolve dispute over convention interpretation).
\item \textsuperscript{288} See \textit{infra} notes 316-32 and accompanying text (discussing advance pricing agreements).
\item \textsuperscript{289} See \textit{infra} notes 292-315, 333-47 and accompanying text (discussing post \textit{factum} remedies available through competent authority negotiations and arbitration).
\end{itemize}
vides the taxpayer with assurance that it will not suffer double taxation if it satisfies certain requirements. The second alternative, bilateral dispute resolution, which currently is limited to international negotiation but which may eventually include meaningful binding arbitration, provides a basis for international agreements on specific tax issues. Despite the existence of some safe harbors and dispute resolution measures, however, these recent developments still lack the potential for much more than a case-by-case means for settling the problem of double taxation.

A. Existing and Proposed Means for Avoiding and Resolving Double Taxation

1. Competent authority negotiation

In the absence of bilaterally approved transfer pricing measures, current international policy calls for negotiation between the competent tax authorities of the involved countries. The competent authority procedure has been adopted by the United States in its

290. See supra note 247-52 and accompanying text (discussing inclusion of safe harbor provision in temporary regulations); see also infra notes 316-32 and accompanying text (discussing advance pricing agreements).


292. See OECD MODEL CONVENTION, supra note 12, art. 25, at 42 (providing taxpayer with recourse to competent authorities when facing taxation that contravenes Convention); U.N. MODEL CONVENTION, supra note 12, art. 25, at 40 (duplicating language of OECD Model Convention). Article 25 of the OECD Model Convention provides:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him [or her] in taxation not in accordance with the provisions of this Convention, he [or she] may, irrespective of the remedies provided by the domestic law of those States, present his [or her] case to the competent authority of the Contracting State of which he [or she] is a resident or, ... to that of the Contracting State of which he [or she] is a national.

2. The competent authority shall endeavor, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention.

3. The competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

OECD MODEL CONVENTION, supra note 12, art. 25, at 42; see also Pending Bilateral Tax Treaties and OECD Tax Convention: Hearing Before the Senate Comm. on Foreign Relations, 101st Cong., 2d Sess. 20 (1990) (prepared statement of Kenneth R. Gideon, assistant secretary for Tax Policy, U.S. Treasury Department) ("A major benefit of an income tax treaty is the establishment of a bilateral dispute mechanism through competent authority agreement.").
own bilateral tax treaties. According to this procedure, taxpayers may avoid double taxation and resort to the competent authorities if, in light of a transfer pricing adjustment made by the tax authority of one country, the other country's tax authority is willing to offset the adjustment by making a "corresponding adjustment." Ordinarily, however, corresponding adjustments are available only when both competent authorities recognize that the conditions of a controlled transfer significantly depart from arm's length.

A taxpayer facing double taxation in excess of the corresponding adjustments that domestic law permits may first appeal to the judicial procedures available in its own country in hopes of obtaining a readjustment of its domestic income allocation. When a taxpayer seeks to assert that the double taxation violates a bilateral tax treaty, however, the Tax Court may be powerless to grant relief.

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293. See, e.g., Tax Convention with the Federal Republic of Germany, art. 25(1), S. TREATY Doc. No. 10, 101st Cong., 2d Sess. 67 (1990) [hereinafter U.S.-Germany Tax Convention] (adopting substance of article 25(1) of U.S. Model Convention permitting resort to competent authorities in cases of double taxation); Income Tax Convention, Apr. 25, 1980, U.S.-U.K., art. 25(1), 31 U.S.T. 5668, 5688 (granting taxpayers right to present cases of double taxation to competent authorities as in U.S. Model Convention article 25(1)); see also U.S. Model Convention, supra note 11, art. 25, at 10,583 (providing in article 25 that "[w]here a person considers that the actions of one or both of the contracting states result or will result for him [or her] in [double] taxation he [or she] may . . . present his [or her] case to competent authority of the contracting state of which he [or she] is a resident or national"); Nancy H. Kaufman, Dispute Resolution Under Tax Treaties: The Developing Role of the Competent Authority, 1984 Wis. Int'l L.J. 101, 102 (noting that competent authority provisions exist in most bilateral tax treaties).

294. See Ian Hunter, Double Taxation—Dispute Resolutions Through Competent Authority, in TRANSFER PRICING FOR INTANGIBLES: A COMMENTARY ON THE WHITE PAPER 64, 65 (Fred C. de Hosson ed., 1989) (observing that income allocation by one country will effect double taxation unless other country makes corresponding adjustment); see also 1984 OECD REPORT, supra note 11, at 9 (discussing utility of corresponding adjustments).

295. See Hunter, supra note 294, at 69 (suggesting that transfer pricing allocation must address dramatic related-party pricing discrepancy before qualifying for negotiated corresponding adjustment).

296. See Kaufman, supra note 293, at 112 (noting that domestic proceedings are taxpayer's first recourse in attempting to remedy problem of double taxation).

297. In the United States this would mean a petition to the Tax Court. See, e.g., Sundstrand Corp. v. Commissioner, 96 T.C. 226, 226 (1991) (petitioning Tax Court for review of § 482 tax adjustments made by IRS); Bausch & Lomb Inc. v. Commissioner, 92 T.C. 525, 525 (1989) (challenging IRS's transfer pricing allocations); Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 996 (1985) (contesting IRS allocations by petition to Tax Court).

298. See Filler v. Commissioner, 74 T.C. 406, 408 (1980) (holding that U.S. Tax Court has no jurisdiction to adjudicate claims for relief of double taxation under U.S.-France Convention). The court in Filler examined the complaint of a French citizen whose U.S. income was taxed in both the United States and France. Id. at 406. Although the court admitted that
Once a taxpayer has exhausted its domestic avenues for relief, it may initiate the competent authority procedure, provided that a treaty exists between the taxpayer's country of domicile and the involved foreign country. The competent authority procedure is essentially a diplomatic process, but it need not utilize standard diplomatic channels. Regardless of the means, however, its purpose is to conform one treaty partner's income allocations to the terms of its treaty. Insofar as the negotiation between the competent authorities may require interpretation of the treaty in question, the competent authority proves that its transfer pricing allocation correctly reflects arm's length considerations.

Filler suggests that the fact that the United States is unable to provide relief does not preclude relief, but that it is more appropriate for a taxpayer's country of residence to remedy the problem. See, e.g., U.S.-Germany Tax Convention, supra note 293, at 61-64 (providing tax credits where taxpayer's income is subject to tax by two nations); Convention with Respect to Taxes on Income and Property, July 28, 1967, U.S.-Fr., art. 23, 19 U.S.T. 5281, 5309-10 (hereinafter Double Taxation Convention) (providing that foreign tax credit may be granted only by taxpayer's country of domicile); U.S. Model Convention, supra note 11, art. 23, at 10,582 (providing tax credits to U.S. taxpayers subject to double taxation). A taxpayer situated like the petitioner in Filler could therefore face the prospect of seeking relief through the judicial systems of both countries, although familiarity with the treaty obligations of one's country would obviate such duplication. Nonetheless, inclusion of the treaty partner as a party to domestic litigation would eliminate the need, or indeed the possibility, for duplication.

299. See Rev. Proc. 91-23, 1991-1 C.B. 534, 539 (curtailing access to competent authority when case is pending before U.S. Tax Court). This does not mean, however, that a taxpayer may not invoke competent authority assistance before instituting an action in a domestic court. See id. (permitting severance of issues pending in judicial proceeding prior to initiating competent authority procedure).

300. See id. at 536 (prescribing recourse to competent authority only in double taxation disputes involving tax treaty partner). When a taxpayer has not sought competent authority assistance, the assistant commissioner of Internal Revenue (International) may initiate negotiations to protect economic interests. Id. at 555. Such a case could arise where a taxpayer has accepted double taxation as a result of income allocation that conflicts with an applicable income tax treaty. Id.


302. See, e.g., U.S.-Germany Tax Convention, supra note 293, at 69 (authorizing direct communication between representatives of competent authorities); OECD Model Convention, supra note 12, art. 25 cmt., para. 4, at 175 (asserting that Convention merely contemplates that competent authorities will communicate directly with one another and not through diplomatic channels); U.S. Model Convention, supra note 11, art. 25, at 10,583 (permitting direct communication between competent authorities).

303. See OECD Model Convention, supra note 12, art. 25, at 42 (compelling competent authorities to correct double taxation not in accordance with Convention); U.S. Model Convention, supra note 11, art. 25, at 10,583 (duplicating language of OECD Model Convention).

304. See OECD Model Convention, supra note 12, art. 25, at 42 (requiring that competent authorities attempt to reach agreement as to proper application or interpretation of Convention); U.S. Model Convention, supra note 11, art. 25, at 10,583 (calling for mutual agreement on treaty interpretation); see also 1984 OECD Report, supra note 11, at 38 (providing that contracting state should not agree to corresponding adjustment unless other competent authority proves that its transfer pricing allocation correctly reflects arm's length considerations).
authorities need not reach agreement. In fact, provisions of the competent authorities' domestic law may prohibit their accession to a disagreeable compromise. Furthermore, a taxpayer need not accept the terms of a competent authority agreement even if one is reached.

The limits of competent authority procedures are readily apparent. First, invocation of competent authority implies an effort by the taxpayer to persuade one country to modify its own tax policy by agreeing to a corresponding adjustment. Second, and more importantly, such an indirect request for a corresponding adjustment implicitly challenges a treaty partner's transfer pricing policy. Third, in any resort to competent authority procedures, at least three parties, including the two competing tax jurisdictions and the aggrieved taxpayer, share a vested interest in the outcome. Unfortunately, the foreign tax authority is absent from a domestic tax adjudication, the taxpayer is absent from competent authority negotiations, and no party has any means to bring all three parties together. Thus, domestic adjudications are not binding on a

305. Cf. OECD Model Convention, supra note 12, art. 25, at 42 (indicating that competent authorities "shall endeavor" to reach agreement but not requiring that agreement be reached); U.S. Model Convention, supra note 11, art. 25, at 10,583 (adopting language of OECD Model Convention).

306. See Mogle, supra note 6, at 726 (observing that conflicting domestic forces may prevent agreement).

307. See Rev. Proc. 91-23, 1991-1 C.B. 534, 541 (permitting petitioner to withdraw, post factum, request for competent authority assistance and to seek alternative relief); Mogle, supra note 6, at 726 (noting that taxpayer is always free to reject results of competent authority negotiations).

308. See Rev. Proc. 91-23, 1991-1 C.B. at 541 ("[T]he primary goal of the U.S. competent authority . . . is to obtain a correlative adjustment from the treaty country."). Where one country has already collected its tax, however, it will naturally be reluctant to refund it. Mogle, supra note 6, at 726.

309. See Mogle, supra note 6, at 726-27 (observing that arm's length methodologies generally come down to judgment of national tax authority and that competent authority negotiations question that judgment).

310. See Wickham & Kerester, supra note 13, at 349 (providing that any determination of transfer pricing adjustment shares same parties in interest, which are (1) domestic tax authority making determination; (2) foreign tax authority that may need to alter its own determination based on domestic determination (and thereby face potential revenue loss); and (3) party who must pay taxes on agreed transfer price).

311. See Wickham & Kerester, supra note 13, at 349 (noting that no existing dispute resolution procedure brings all parties in interest to table); see also infra notes 362-64 and accompanying text (proposing trilateral dispute resolution). But see Mogle, supra note 6, at 727-30 (discussing proactive participation in competent authority procedure by taxpayer). Proactive participation by a taxpayer generally involves presenting the arguments of a taxpayer and a taxpayer's representatives to both competent authorities. Mogle, supra note 6, at 728. Mogle suggests that proactive participation provides three benefits. First, it permits a taxpayer to influence the competent authorities' decisions independent of face-to-face meetings between competent authorities. Id. Second, because a taxpayer necessarily has a far better understanding of the facts of its case, it is in a much better position to explain the arm's length nature of a proposed income allocation. Id. Finally, the independent interest that a taxpayer
foreign tax jurisdiction, and successful competent authority agreements are not binding on a dissatisfied taxpayer. Finally, competent authority agreements and the negotiations preceding them are confidential. This confidentiality results in no meaningful agreement between governments because it provides no basis either for tax planning or for informed tax enforcement.

2. Advance pricing agreements

One way a taxpayer could secure a safe harbor, or positive assurance against unexpected transfer pricing allocations, would be to obtain a preliminary agreement from its own competent authority as

has in the resolution of the competent authority process ensures that it will be able to dedicate more resources to the negotiation than could the competent authorities themselves. Id.

At the same time, proactive participation in the competent authority procedure could prejudice a taxpayer in subsequent domestic litigation because, to be effective in proactive participation, a taxpayer must be willing to support the disputed transfer pricing allocation. Id. at 729. This threshold requirement would effectively preclude domestic litigation if the competent authorities failed to agree on an allocation because support for a domestic competent authority's position would be nearly impossible to disavow before the Tax Court. Id.

312. See Wickham & Kerester, supra note 13, at 349 (indicating that because domestic court cannot interplead foreign tax authority, foreign tax authority will not be subject to domestic adjudications).

313. See supra note 307 and accompanying text (discussing taxpayer's right to reject agreement).

314. See Wickham & Kerester, supra note 13, at 354 (noting that neither competent authority agreements nor rationales for accepting or rejecting agreements are made public).

315. See Wickham & Kerester, supra note 13, at 361 (advocating modified bilateral and multilateral standards for competent authority procedures that are open and bear some measure of precedential effect). Measures to make the procedures public were proposed in 1965 by Stanley Surrey, assistant secretary of the U.S. Treasury Department for Tax Policy. Mr. Surrey observed:

[T]he rules which the United States regards as proper to allocate income to our parent companies from transactions with their foreign subsidiaries are the rules we must be willing to accept when the subsidiary is here and its parent is a foreign corporation. This factor should have an effect in tempering the international assertion of rigid positions, and thus make it easier to achieve international accommodation. For it is clear that this must be the ultimate goal, an internationally acceptable set of rational rules to govern the allocation of international income arising through these transactions.

Stanley Surrey, Address to the Tax Institute of America (Dec. 1965), quoted in Langbein, supra note 34, at 647.

316. See 1979 OECD REPORT, supra note 16, at 16-17 (discussing efficacy of safe harbors). In addressing the possibility of creating safe harbors from income allocations, the OECD reserved its approval for fixed safe harbors, or standardized ranges within which a taxpayer's transfer prices would receive automatic acceptance, because such rules would be unavoidably arbitrary. See id. (contending that fixed-range safe harbors "are likely to be arbitrary since they will rarely fit exactly the varying circumstances even of enterprises in the same trade or business"). When it addressed the topic in the White Paper, the IRS similarly noted that "[t]he government's experience in the section 482 area has been that safe harbors have generally treated amounts as arm's length prices that were usually different from market rates." White Paper, supra note 59, at 481. Asserting that developing safe harbors under § 482 would require constant reference to the variable factual conditions of § 482 cases, the IRS resisted recommending inclusion of safe harbors in the revised regulations. See id. at 482 (noting safe harbor deficiencies and reserving favorable recommendation). But see Temp. Treas. Reg. § 1.482-1T(f)(1), 58 Fed. Reg. 5263, 5281 (1993) (providing optional safe harbor for small
to the methodologies that both taxpayer and tax authority would apply with respect to the taxpayer's transfer pricing. Such a procedure, referred to as an "advanced pricing agreement" (APA), was recently authorized by the IRS.317

The purpose of an APA is simply to establish an arrangement between a taxpayer and the competent authority as to the tax treatment of the taxpayer's controlled transactions.318 In so doing, the procedure sets forth the methodology that will be used to allocate income earned in the relevant transfers319 with direct reference to the specific nature of those transfers.320 In most cases, the APA will also preset appropriate transfer prices.321 In addition, the APA procedure provides means for obtaining bilateral competent authority agreement in advance of any double taxation problems.322

An APA is binding on both the taxpayer and the IRS,323 and a taxpayer who complies with the APA's terms is free from unexpected IRS allocations.324 Nonetheless, the IRS, as a competent authority, may deviate from the terms of an APA if necessary to bring about a subsequent competent authority agreement.325 Unfortunately, APAs, like competent authority procedures, are kept confidential.326 At the same time, the IRS reportedly is "sensitive to charges of creating a private body of law"327 and has suggested that it may make public the considerations relevant to APA negotiations

318. See id. at 527 (explaining principles underlying APA provisions).
319. See id. (seeking agreement on appropriate transfer pricing methodology).
320. See id. (providing for stipulation on factual nature of related-party transfers).
321. See id. (noting that advance allocation will be omitted from APA only "in appropriate cases").
322. See id. (providing for preemptive consultation on contents of APA between competent authorities of treaty partners). If the competent authorities fail to agree on the terms of the APA or any corresponding adjustments thereto, the taxpayer must provide "good and sufficient" reasons for executing the APA without the treaty partners' accession. See id. at 531 (discussing appropriate circumstances for continuing APA negotiations in absence of competent authority agreement).
323. Id. at 531.
324. Cf. id. at 532-33 (providing for IRS examination to verify taxpayer compliance with APA terms).
325. See id. at 531 (noting that if "double taxation occurs, the U.S. competent authority may deviate from the terms and conditions of the APA in an attempt to negotiate a settlement" with treaty partner's competent authority). This deviation can occur only if the taxpayer has not obtained prior competent authority agreement on the terms of the APA. See supra note 322 and accompanying text (discussing preemptive negotiation of competent authority agreement).
326. See John Turro, IRS Official Says No APA Disclosure, But Generic Information To Be Provided, 4 Tax Notes Int'l 709, 709 (1992) (reporting comments by IRS Associate Chief Counsel Robert Culbertson that APAs are not disclosed to public).
327. Id.
and the approaches that work best with respect to certain types of transactions.\textsuperscript{328}

Preliminary industry experience with the APA has been generally positive.\textsuperscript{329} Furthermore, competent authority negotiations over APAs have yielded some substantial, if informal, international agreements.\textsuperscript{330} Unfortunately, the secrecy of advance pricing agreements is extremely troubling. Not only does the lack of open procedures and transfer pricing agreements leave the taxpayer without significant guidance in presenting its case for an APA,\textsuperscript{331} but it also provides a punitive approach toward transfer pricing that could penalize foreign taxpayers while protecting U.S. concerns.\textsuperscript{332}

3. \textit{Arbitration}

The existing arrangement seems to cry out for impartial arbitration. In fact, the OECD Model Convention permits competent authorities to resort to arbitration when they are unable to reach an appropriate agreement.\textsuperscript{333} Unfortunately, the OECD Convention's suggestion has been followed rarely, if at all.\textsuperscript{334} Bilateral income tax treaties have begun to include arbitration provisions,\textsuperscript{335} however,

\textsuperscript{328} \textit{Id.}
\textsuperscript{329} \textit{See, e.g.,} John Turro, \textit{Apple Computer Readies for APA Replay,} \textit{4 Tax Notes Int'l} 278, 278 (1992) (noting that Apple's experience, which shows that preparation for initial APA provides groundwork for negotiation of subsequent agreements, is demonstrative of industry-wide positive experience with APAs).
\textsuperscript{330} \textit{See id.} at 279 (reporting that IRS has so far concluded advance pricing agreements relating to Japan, Canada, United Kingdom, Switzerland, and Australia). Negotiations are apparently under way with Norway, the Netherlands, Germany, Singapore, Hong Kong, and, notably, Brazil, which is not a U.S. tax treaty partner. \textit{Id.}
\textsuperscript{331} \textit{See Turro, supra} note 329, at 278 (discussing Apple's laborious process in preparing to negotiate first-time pricing agreement and noting that lack of information regarding discussions between IRS and foreign tax authorities contributed to difficulty of process).
\textsuperscript{332} \textit{See Wickham & Kerester, supra} note 13, at 354 (asserting that secret negotiation leaves open possibility for unfair treatment of foreign companies involved in APA requests).
\textsuperscript{333} \textit{See OECD Model Convention, supra} note 12, art. 25 cmt., paras. 43-45, at 182 (observing occasion when competent authorities may seek independent advisory opinion of international organization or independent arbitrators).
\textsuperscript{334} \textit{See 1984 OECD Report, supra} note 11, at 18 (commenting that because no one has taken advantage of arbitration opportunities, it is difficult to ascertain how useful they might be).
\textsuperscript{335} \textit{See Killius, supra} note 291, at 438-39 (discussing inclusion of arbitration provisions in income tax treaties between Germany and Sweden and United States and Germany). Treaty-based arbitration should not be confused with voluntary referral to arbitration from the U.S. Tax Court. Tax Court rule 124 provides that the parties to an issue before the court may move to submit the issue to binding arbitration. \textit{Tax Ct. R.P.} 124(a). Because the rule is limited to matters over which the Tax Court has jurisdiction, however, such arbitration is inapplicable to international double taxation disputes. \textit{See supra} note 298 and accompanying text (discussing power of Tax Court and Tax Court's decision in \textit{Filler v. Commissioner}). Parties have invoked rule 124 only recently and only in one \textsection 482 dispute. \textit{See John E. O'Grady, Apple and IRS Enter into First Transfer-Pricing Arbitration Under U.S. Tax Court Rule,} \textit{4 Tax Notes Int'l} 518, 518 (1992) (observing that Apple case involved first referral of \textsection 482 dispute to arbitration).
and arbitration may prove to be an excellent vehicle for resolving the confusion that will doubtless result from the new U.S. regulations. The United States-Germany Tax Convention, for example, adopts the arbitration measures suggested by the OECD Model Convention. 336 Although it prescribes impartial arbitration only by agreement of all three parties in interest, 337 voluntary arbitration occupies the middle ground between a competent authority stalemate and the subordination of fiscal self-determination through accession to a corresponding adjustment. 338

The arbitration provision in the United States-Germany Tax Convention is an excellent first step if only because it brings all three interested parties to the same table. Although a trilateral settlement may be procedurally cumbersome, such a scheme doubtless provides the most equitable result possible because it permits simultaneous consideration of the concerns of all parties involved. 339 Moreover, although it does not carry full precedential effect, 340 the arbitration is binding. 341

In observance of the problems of double taxation, the European Community (EC) followed the OECD Model Convention's suggestion and agreed in 1990 to a draft double taxation convention that

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336. See U.S.-Germany Tax Convention, supra note 293, art. 25(5), at 69 (permitting submission of unresolved disagreements to arbitration on mutual agreement of competent authorities); see also supra note 333 and accompanying text (discussing arbitration provision in OECD Model Convention). The protocol to article 25(5) of the U.S.-Germany Tax Convention provides:

- The competent authorities may agree to invoke arbitration in a specific case only after fully exhausting [competent authority negotiations], and if the taxpayer(s) consent(s) to the arbitration and agree(s) in writing to be bound by the arbitration decision. The competent authorities will not generally accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either Contracting State.


337. See Killius, supra note 291, at 439 (noting decision of German Government to establish arbitration procedure requiring consent of all parties rather than to require mandatory arbitration).

338. See 1984 OECD REPORT, supra note 11, at 39 (rejecting compulsory arbitration because "adoption of such a procedure would represent an unacceptable surrender of fiscal sovereignty"). But see Convention 90/463 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, art. 7(1), 1990 O.J. (L 225) 10, 13 [hereinafter EC Arbitration Convention] (compelling arbitration under prescribed circumstances).

339. See infra notes 362-64 and accompanying text (discussing advantages of trilateral dispute resolution process).

340. See U.S.-Germany Tax Convention, supra note 293, at 18 (stating that arbitral decisions are not precedential). Nonetheless, the diplomatic exchanges accompanying the treaty provide that such arbitral decisions "may . . . be taken into account in other cases where appropriate." Id.

341. U.S.-Germany Tax Convention, supra note 293, at 94 ("The decision of the arbitration board in a particular case shall be binding on both Contracting States with respect to that case.").
provides for binding arbitration.\textsuperscript{342} What is most notable about the EC Arbitration Convention is the openness of its procedures. When a contracting state intends to make an arm's length adjustment, the state must provide the taxpayer with timely notification of its intentions and allow it to inform its related party so as to permit the related party an opportunity to notify the other contracting state.\textsuperscript{343} If the initial communication of intent fails to elicit an agreement, a taxpayer is free to invoke competent authority proceedings generally by the means set forth in the OECD Model Convention.\textsuperscript{344} Finally, if the competent authorities fail to settle the dispute within two years,\textsuperscript{345} they must refer the dispute to an "advisory commission," or arbitral tribunal.\textsuperscript{346} The arbitration will become binding six months after its delivery unless the competent authorities agree to a contrary settlement before that time.\textsuperscript{347}

B. The Limits of Unilateral Enforcement and Bilateral Dispute Resolution

Although they are a last resort for a taxpayer who faces double taxation,\textsuperscript{348} competent authority proceedings offer some hope for encouraging international agreement on a new international transfer pricing standard. Admittedly, the new § 482 regulations come

\textsuperscript{342} See EC Arbitration Convention, supra note 338, at 10-16 (acknowledging importance of elimination of double taxation in effecting Convention and including binding arbitration in Convention's provisions).

\textsuperscript{343} EC Arbitration Convention, supra note 338, art. 5, at 13. Although this provision is not particularly dramatic, its effects are important. First, it provides an open, if indirect, line of communication through which contracting states may voice their interpretations of arm's length before double taxation problems manifest. By providing the treaty partner of a country making an adjustment with an opportunity to review the adjustment and make an informed corresponding adjustment, the Convention may prevent the partner's need to resort to international negotiation. See id. (precluding application of competent authority proceedings and arbitration if contracting states agree to corresponding adjustment). Further, such communication may in time bring about bilateral and multilateral understanding and agreement on general transfer pricing principles. See Wickham & Kerester, supra note 13, at 361 (positing that making proceedings public will be beneficial to all involved and discussing ways to accomplish openness).

\textsuperscript{344} EC Arbitration Convention, supra note 338, art. 6, at 13; see OECD Model Convention, supra note 12, art. 25, at 42 (providing recourse to competent authority).

\textsuperscript{345} EC Arbitration Convention, supra note 338, art. 7(1), at 13. This time limit may be waived by mutual agreement of both competent authorities and the affected taxpayer. Id.

\textsuperscript{346} EC Arbitration Convention, supra note 338, art. 7(1), at 13. The arbitral panel is empowered to demand documents from any party to the dispute. See id. art. 10(1), at 14 (permitting arbitral panel to require any documentation that does not implicate state secrets or economic security). The taxpayer may appear at either the tribunal's request or its own initiative. Id. art. 10(2), at 14-15.

\textsuperscript{347} EC Arbitration Convention, supra note 338, art. 12(1), at 15.

\textsuperscript{348} See OECD Model Convention, supra note 12, art. 25 cmt., para. 6, at 175 (commenting that taxpayer facing double taxation must first litigate in each country involved before instituting competent authority proceedings).
in the wake of perceived revenue losses in the United States, and they may appear to be coercive, forcing confusing pricing standards down the throats of taxpayers and foreign tax authorities alike. Nonetheless, the regulations' methodology is unbiased. If applied bilaterally rather than unilaterally, the regulations would stand as much chance of diverting related-party income to a foreign jurisdiction as to the United States. Although competent authority proceedings and arbitration may provide short-term assistance in alleviating acute problems, such case-by-case resolution will not solve the underlying problem of discordant transfer pricing policies. Nonetheless, even though the essential problem is properly the subject for bilateral treaty negotiations, individual cases may provide a basis on which to build international understanding of what is at stake in transfer pricing.

C. The Next Step

Any solution to the problem of double taxation cannot be reached unilaterally. Regardless of the accuracy or even celestial perfection of any one nation's transfer pricing methodology, double taxation will still result if other nations do not agree with that methodology. The best that can be said is that the elimination of double taxation will require multilateral consensus. Obtaining such international consensus, however, depends on a number of factors that do not exist within the current international system.

349. See supra notes 130-33 and accompanying text (explaining that Congress amended § 482 in 1986 in part because of revenue loss perception).
350. Cf. Bellstedt, supra note 156, at 66 (reporting that author, German and international tax practitioner, had read White Paper "with great interest and indeed with a mixture of amusement and horror").
351. See Boidman, supra note 141, at 420 (opining that new U.S. regulations would apply equally to inbound and outbound transfers); cf. Stanley Surrey, Address to the Tax Institute of America (Dec. 1965), quoted in Langbein, supra note 34, at 647 (asserting that United States should be willing to accept countervailing adjustments equivalent to those imposed by U.S. regulation).
352. See Wickham & Kerester, supra note 13, at 341 (asserting that case-by-case analysis under current system "is a horse-and-buggy mechanism that is woefully inadequate to the demands being made on it").
353. See Stanley Surrey, Address to the Tax Institute of America (Dec. 1965), quoted in Langbein, supra note 34, at 647 ("[I]f our unilateral rules do not mesh with those of other countries the result will be double taxation, the tax burden of which will be borne either by one government through the foreign tax credit or by the taxpayer, with the other government obtaining an unwarranted benefit.").
355. For example, nothing in the existing systems for dispute resolution compels agreement between competent authorities. Although the U.S.-Germany Tax Treaty and the EC Arbitration Convention do provide for binding arbitration, the arbitration provisions of those conventions are not mandatory. See, e.g., EC Arbitration Convention, supra note 338, art. 7(1), at 13 (permitting but not requiring parties to resort to arbitration, results of which are bind-
As the aforementioned suggests, potential international discord arising over one country’s application of specific, unilateral transfer pricing rules may be ameliorated by altering those rules.\textsuperscript{356} The ultimate solution, however, may be reached only by international agreement on uniform rules.\textsuperscript{357} Regardless of international acceptance of the arm’s length standard, the standard is not an end in itself, but a means.\textsuperscript{358} That is, “arm’s length” does nothing more than provide a rational basis on which to establish which country may claim the right to certain tax revenues.\textsuperscript{359} The differences of opinion between tax jurisdictions therefore represent little more than differences as to what the term “arm’s length” actually means. This is not to say that the method used to determine an arm’s length price is irrelevant, but that determination of arm’s length market pricing is still inferior to the goal of geographically allocating revenue among competing tax jurisdictions.\textsuperscript{360} The new §482 regulations appear to be on the right track if only because of their meticulous use of data derived from transactions among unrelated parties.\textsuperscript{361} Nonetheless, they are derailed by their focus on the operation of allocating income among related parties rather than allocating revenue among the nations in which those related parties reside.

1. **Triangulating the dispute resolution process**

The first step in obtaining multilateral agreement would be to permit all parties in interest to a transfer pricing allocation to present their views in domestic, international, or competent authority proceedings. From a governmental perspective, permission to enter
the domestic proceedings of another country would not only permit
the views of one country's competent authority to be heard in a for-
eign forum, but would also grant valuable insight into the operation
of foreign transfer pricing mechanisms. Understanding such mech-
anisms, of course, would be a major step toward bilateral and multi-
lateral harmonization of transfer pricing policy.

Furthermore, trilateral proceedings would permit a single pro-
ceeding to take into account all information relevant to that pro-
ceeding. Thus, a domestic judicial proceeding could consider the
broader effects of its determination by reference to the tax policies
of the foreign government. Similarly, competent authority proceed-
ings in which the taxpayer could become an independent party of
right would benefit from the taxpayer's intimate understanding of
the details of its own tax planning and transfer pricing strategy.362

To a small extent, the IRS's advance pricing agreement policy tri-
angulates one means for constructing a safe harbor by permitting
prior agreement by a foreign competent authority.363 Nonetheless,
the APA procedure suffers from the same malaise that afflicts the
competent authority process because it provides no assurance of bi-
lateral acceptance.364 Therefore, even if a taxpayer is successful in
obtaining a favorable APA, it is not assured that it will be free from
double taxation.

2. Opening lines of communication among taxpayers and tax authorities

No true solution to the double taxation problem may be found in
the absence of meaningful communication between governments
and their taxpayers.365 In spite of the numerous benefits they offer,
competent authority negotiations, bilateral arbitration, and APAs
are closed proceedings, and the wisdom they may provide remains
out of the public eye.366 The measures now in place, effective
though they may be, cannot therefore benefit from their own prece-
dent.367 These shortcomings do, however, suggest their own solu-

362. See Mogle, supra note 6, at 277-78 (observing that true trilateral hearing would permit
taxpayer independent voice in proceeding and thereby give authorities advantage of hearing
taxpayer's perspective while limiting prejudicial effects of taxpayer's proactive participation).
363. See Rev. Proc. 91-22, 1991-1 C.B. 526, 530 (allowing for agreements between compe-
tent authorities concerning APAs).
364. See id. at 531 (discussing legal effect of APA and noting that APA is only binding
between individual taxpayers and IRS).
365. See Hunter, supra note 294, at 65 (proposing that listening to taxpayers' views and
cooperation between nations is only way to resolve problems of double taxation).
366. See Wickham & Kerester, supra note 13, at 354 (attacking confidential nature of ex-
isting dispute resolution measures on grounds that they offer no guidelines as to generally
applicable law and that they subject competitors to unequal treatment).
367. See supra notes 314-15, 326-28 and accompanying text (discussing problems with
tion. If the end is agreement and multilateral understanding, the means must be one that fully discloses the intentions and policies of each party involved.

First, the results of all competent authority negotiations should be made public and should be given precedential value. Not only would such a policy provide a means for streamlining future negotiations by offering a clear course of action under a given set of circumstances, but published guidelines would also provide taxpayers more secure means of setting their own transfer pricing policies in light of the stated policies of the governments to which they must answer.

Second, the existing policy of sealing all APAs means that the agreements' benefits can only be enjoyed by the select few who can afford the costs involved. By keeping the details of specific transfer pricing cases confidential, the IRS risks creating a private body of law and incurring the wrath of future domestic litigation and interminable competent authority negotiations. By opening the operative details of APAs to review by competent authorities and taxpayers, the often confusing details of U.S. transfer pricing policy and the means to satisfy the requirements of § 482 will be made far clearer to all involved.

Finally, arbitration provisions such as those in the United States-Germany Tax Convention and the EC Arbitration Convention should be invoked whenever possible and should provide for publication of arbitral decisions. Openness in arbitration proceedings could not help but illuminate the goals and policies of the nations involved, and the resultant body of law would bring about a means for settling future disputes that is far more useful than any of those currently available.

**Conclusion**

The United States imposition of new transfer pricing regulations has caused unrest and unease among foreign tax authorities who

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keeping competent authority agreements and APAs confidential and advocating publication of agreements and negotiations involved to provide precedential value).

368. *See* Wickham & Kerester, *supra* note 13, at 354 (asserting that “[t]axation by secret negotiation and agreement instead of by prepublished rules of general application . . . does not comport with [this country's] democratic political values” because it creates unfair disparity between tax treatment of large, powerful businesses and smaller firms).

369. *See supra* notes 336-47 and accompanying text (discussing arbitration provisions in U.S.-Germany Tax Convention and EC Arbitration Convention). Although the EC Arbitration Convention permits publication of decisions, it does not mandate it. *See* EC Arbitration Convention, *supra* note 338, art. 12(2), at 15 (providing that decisions reached by competent authorities may be published with consent of parties involved).
remain puzzled by the regulations' application and who feel threatened by the possible implications for their own fiscal policies. The problem of transfer pricing disputes is not new, but it is expanding at an ever-increasing rate.\textsuperscript{370} International unity will be the only means to avoid an avalanche of double taxation disputes. Surviving that upheaval will require learning the lessons taught by previous disputes. That in turn will require open communication among tax authorities and taxpayers in ways that are not yet available under international conventions. The solution remains hanging in space, as one author has put it, "in much the same way that bricks don't."\textsuperscript{371} The decision now is whether to stand and wait for the brick's impact, to run and hide, or to summon the courage to catch it and mortar it into a mending wall.

\textsuperscript{370} See supra notes 1-3 and accompanying text (discussing growing interdependence of world economy and increased number of multinational businesses in recent years).