INTERNATIONAL TRANSFER PRICING RULES:
UNCONVENTIONAL WISDOM

Eugene E. Lester

I. INTRODUCTION .............................................................. 284
II. BACKGROUND ............................................................... 285
III. DEVELOPMENTS .......................................................... 288
   A. The Barclays Bank Decision ........................................ 288
   B. The OECD Draft Report on Transfer Pricing ....................... 289
      1. The Arm's Length Principle .................................. 289
      2. Transaction-Based Methods .................................. 290
      3. Other Methods ................................................. 291
   C. The United States Treasury Regulations Under Section 482 .... 292
      1. Methods ......................................................... 292
      2. The Best Method Rule ........................................ 293
      3. Advance Pricing Agreements .................................. 293
   D. Steps Toward Global Formulary Apportionment .................... 294
IV. CONVENTIONAL ARGUMENTS ............................................ 295
   A. Criticism of the Arm's Length Principle ......................... 295
      1. Theoretical Arguments ....................................... 295
      2. Empirical Arguments ....................................... 297
      3. Practical Arguments ....................................... 298
   B. Benefits of the Arm's Length Principle ........................ 298
   C. Criticism of Global Formulary Apportionment .................... 299
      1. Theoretical Argument ....................................... 299
      2. Practical Arguments ....................................... 299
   D. Benefits of Global Formulary Apportionment .................... 300
V. UNCONVENTIONAL WISDOM ............................................. 300

* Candidate for Juris Doctor, 1996, Wake Forest University School of Law; B.S., 1993, summa cum laude, State University of New York at Binghampton.
I. INTRODUCTION

In the sixteenth century, the Spanish Empire was larger and "more powerful than any other European state since the Roman Empire."¹ A historian of that time period said, "[t]he sun never sets on the dominion of the King of Spain."² Tax historian Charles Adams asserted that Imperial Spain's failure to reform its tax system significantly contributed to its demise.³ Oxford's leading scholar on Imperial Spain described Spain's taxes as follows:

[S]panish industry was strangled by the most burdensome and complicated system of taxation that human folly can devise . . . . The taxpayer, overburdened with imposts, was entangled with a network of regulations to prevent evasion . . . . He was thus crippled at every step by the deadly influence of the anomalous and incongruous accumulation of exactions.⁴

Today's international transfer pricing rules resemble Imperial Spain's tax system. Although no modern nation can boast that the sun never sets on its domain, many multinational enterprise (MNE) groups can. MNE groups are the engine of global commerce and local prosperity.⁵ Imperial Spain's fate admonishes nations to balance their sovereign right to tax with uniform and predictable tax treatment of MNE groups.⁶

¹. CHARLES ADAMS, FOR GOOD AND EVIL 185 (1993).
². Id.
³. Id.
⁴. Id. at 196 (quoting RETREVER DAVIES, SPAIN IN DECLINE 1621-1700, at 105 (1957)).
⁵. "Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises." Organization of Economic Cooperation and Development Draft Discussion on Transfer Pricing (OECD, Paris (1994)), reprinted in 8-9 INTERTAX 314, 318 (1994) [hereinafter OECD Report].
⁷. Id.
Part I of this comment explains transfer pricing, defines the choices for taxing controlled transactions, and briefly recounts the development of international transfer pricing rules. Part II reviews recent developments in the international transfer pricing debate over the arm's length principle and global formulary apportionment. Part III summarizes the arguments for and against the use of each standard. Finally, Part IV proposes that transfer pricing rules should reflect a continuum of both the arm's length principle and the unitary approach from the comparable uncontrolled price method (CUP) to formulary apportionment.

II. BACKGROUND

Montesquieu observed that direct taxes on the individual are more natural to slavery, whereas indirect taxes on transactions are more natural to liberty. In the United States, the income tax is perceived as an indirect tax, a tax on the receipt of income. While the relationship between liberty and income taxes may seem tenuous, the relationship between government revenue and income is not. A government's income tax receipts are directly related to the amount of taxable income within its taxing jurisdiction. The amount of income is at the heart of transfer prices.

The amount of income received is equal to the price paid for goods or services less the cost. When the price of goods or services is determined by negotiations between independent self-interested enterprises, the price is said to be determined by the market. The transaction is called arm's length or uncontrolled because the enterprises are trying to maximize their respective interests. For example, assume that Bow Enterprise and Arrow Enterprise are two uncontrolled corporations dealing at arm's length. Arrow wants to get the highest price possible for the arrows it sells and Bow wants to pay as little as possible for the arrows it needs. Arrow sells 100 arrows at one dollar each to Bow. The market price for an arrow is one dollar. Arrow receives $100 in income and has taxable receipts up to $100. Generally, governments view market transactions as the norm. Income tax revenue from market transactions is satisfactory.

However, not all prices are determined by the market. When the price of goods or services is set by negotiations between related

8. Formulary apportionment is also known as the unitary approach.
9. ADAMS, supra note 1, at 278 (quoting BARON DE MONTESQUIEU, SPIRIT OF LAWS 267 (Thomas Nugent trans., 1991)).
10. Id. at 313. However, in Canada and the United Kingdom, income taxes are classified as direct taxes. Id.
enterprises, the price is the intercompany transfer price. The transfer price may be the market price or it may reflect other interests of the related group. The transaction is called controlled because enterprises have the opportunity to maximize the collective interests of the enterprise group, as well as their own. Tax avoidance is always one of those interests.

Recall the example in which the market price of an arrow was one dollar. Now, assume that Arrow Enterprise is a related corporation in the Bow & Arrow Group. Assume further that Arrow pays lots of taxes on its income over one dollar, while Bow & Arrow is virtually tax exempt. Arrow sells 100 arrows at one cent each to Bow & Arrow. The transfer price for an arrow is one cent. Arrow receives one dollar in income. Then, Bow & Arrow sells 100 arrows at the market price of one dollar each and receives $100 in income. Because Arrow’s income is not over one dollar it pays no taxes. And since Bow & Arrow is virtually tax exempt, it receives $100 basically tax free. Generally, governments view transfer prices as anomalies when they do not follow market prices. Income tax revenue from controlled transactions is unsatisfactory to the extent controlled transactions deviate from market norms.

Governments have two choices for taxing controlled transactions. They can treat controlled transactions as if they were market transactions, or they can choose not to tax controlled transactions at all. If a government does not tax controlled transactions, they usually treat controlled enterprise groups as a single business unit for tax purposes. The first alternative is the arm’s length principle and the second is the unitary approach. The arm’s length principle imposes a comparable market price on controlled transactions. Conversely, the unitary approach does not try to achieve comparability among transactions. It uses a formula to apportion income between controlled enterprises.

11. There are several possible reasons for the tax disparity between Arrow and Bow & Arrow. For example, differences in Arrow and Bow & Arrow’s size, capitalization, or taxing jurisdiction could account for the difference.
14. Id.
15. Id.
Remember the last example where the market price of an arrow was one dollar, and the Bow & Arrow Group’s transfer price of an arrow was one cent. Under the arm’s length approach, the controlled transaction between Arrow and Bow & Arrow is treated as if it was a market transaction for tax purposes. A market price of one dollar is imposed on the sale of 100 arrows. Therefore, highly taxed Arrow receives up to $100 in taxable income and virtually tax free Bow & Arrow has no taxable receipts.

Under the unitary approach, the controlled transaction between Arrow and Bow & Arrow is not taxed. The Bow & Arrow Group is treated as a single business unit for tax purposes. After the sale of arrows, Bow & Arrow Group has $100 in income. A formula using some combination of property, payroll, and sales as factors is used to apportion income between Bow & Arrow Group’s controlled enterprises.

Since 1921, section 482 has authorized the United States Tax Commissioner to reallocate income among controlled enterprises using the arm’s length principle. The states, however, use the unitary approach to apportion income between multi-state controlled enterprises. Transfer pricing decisions take on international dimensions when the related enterprises are located in different sovereign taxing jurisdictions. MNE groups may manipulate transfer prices to shift income from high tax jurisdictions to low tax jurisdictions in order to avoid taxes.

In response to the growth in international commerce and the spread of MNE groups, countries began to evaluate their tax legislation with regard to transfer pricing. In 1968, the United States Treasury issued new arm’s length transfer pricing regulations under section 482. At the same time, the Organization of Economic Cooperation and Development Committee (OECD) on Fiscal Affairs began work in this area. In 1979, the OECD published transfer pricing guidelines which endorsed the arm’s length principle. These guidelines were followed by two OECD reports on transfer pricing in 1984 and 1992. OECD guidelines form the basis of several member countries’ national tax legislation. Since 1980, France, Italy, the United Kingdom, Germany, Japan, Korea, Canada, Australia, and the United States have published new or revised transfer pricing rules.


18. Id.

19. Id.
III. DEVELOPMENTS

Part II summarizes three major developments in the area of international transfer pricing in 1994. In June, the United States Supreme Court decided Barclays Bank v. Franchise Board of California. In June, the OECD released a partial draft of a report that will revise the 1979 OECD Report on Transfer Pricing. In July, the United States Treasury Department also published the final version of the transfer pricing regulations under section 482 of the Internal Revenue Code.

A. The Barclays Bank Decision

In Barclays Bank, the United States Supreme Court held that California’s formulary apportionment method as applied to MNE groups with in-state operations did not violate the Commerce and Due Process Clauses of the United States Constitution. Although the Barclays Bank decision does not address federal transfer pricing rules, the opinion implies that Congress could adopt federal unitary taxation under section 482. The Court emphasized that Congress, not the Executive, constitutionally determines the United States foreign commercial policy. The Court also implied that the United States international tax policy was a political question outside the scope of the Supreme Court’s Article III jurisdiction. Furthermore, the Court put formula apportionment on the same constitutional plane as the arm’s length principle. The Court held that California’s tax passed due process scrutiny because “[r]ules governing international multi-jurisdictional income allocation have an inescapable imprecision given the complexity of the subject matter.” The Court also

22. OECD Report, supra note 5, at 314.
24. California’s corporate franchise tax was determined by a “worldwide combined reporting” method. Barclays Bank, 114 U.S. at 2271. This method attributed a portion of the taxpayer’s worldwide income to California based on “the average of the proportions of worldwide payroll, property, and sales located in California” Id. at 2272.
25. Id.
27. Barclays Bank, 114 U.S. at 2285.
28. Id.
29. Id. at 2279.
held that formulary apportionment was as effective as the arm's length principle in avoiding double taxation.\textsuperscript{30} The Supreme Court's validation of state unitary taxation has provided support for federal global formulary apportionment.\textsuperscript{31}

B. The OECD Draft Report on Transfer Pricing

Conversely, the OECD has reaffirmed the arm's length principle as the international standard and has expressly rejected global formulary apportionment as an alternative in its draft report on transfer pricing.\textsuperscript{32} Part I of the report, Principles and Methods, has been released in draft form for public comment, as work continues on Part II, Applications, and Part III, Special Topics.\textsuperscript{33} Part I of the draft report states the arm's length principle and explains why it is superior to the unitary approach.\textsuperscript{34} It discusses general application of the arm's length standard and describes transaction-based methods.\textsuperscript{35} Part I also describes other methods and their relative usefulness in realizing the arm's length principle.\textsuperscript{36}

1. The Arm's Length Principle

The OECD draft report relies on paragraph one of Article 9 of the OECD Model Tax Convention\textsuperscript{37} as the authoritative statement of the arm's length principle.\textsuperscript{38} The Model Tax Convention provides that

[When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so

\textsuperscript{30} Id. at 2280 (citing Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 193 (1983)).
\textsuperscript{31} Evans, supra note 26, at 229.
\textsuperscript{32} OECD Report, supra note 5, at 325 para. 31.
\textsuperscript{33} Id. at 314-15. Part I was issued for public comment in July 1994. It will be finalized with Part II in 1995. Part III is expected to be available at the end of 1996.
\textsuperscript{34} Id.
\textsuperscript{35} Id.
\textsuperscript{36} See Becker, supra note 17, at 356.
\textsuperscript{37} The OECD Model Convention forms the basis of bilateral tax treaties among OECD member and some non-member countries. OECD Report, supra note 5, at 323 para. 23.
\textsuperscript{38} Id.
accrued, may be included in the profits of that enterprise and taxed accordingly. 39

The report's reasons for adopting the arm's length principle and rejecting the unitary approach will be described in Part II of this comment.

Next, the report discusses factors determining comparability. 40 The arm's length principle requires the comparison of a controlled transaction with an uncontrolled transaction to determine an arm's length price. 41 The accuracy of the arm's length price depends on the degree of comparability among the transactions. 42 In this regard, the report determines to what extent several transactional factors, such as risk and business strategies, effect the comparability of the transactions. 43

2. Transaction-Based Methods

The report also discusses three types of transaction-based methods: the CUP method, the resale price method (RPM), and the cost plus method. The CUP method estimates an arm's length price from a comparable uncontrolled transaction. 44 If the CUP method is inapplicable, then the RPM may be useful. 45 The resale price method is the price at which a good that has been bought from an associated enterprise is resold to an independent enterprise. 46 Then, the resale price is reduced by a comparable uncontrolled profit margin to work back to an arm's length price. 47 However, if the CUP method is inapplicable, the cost plus method may be useful. The cost plus method starts with the costs incurred by a member of an associated enterprise. 48 Then, a comparable uncontrolled mark-up is added to that cost to achieve an arm's length price. 49

Even though the report encourages flexibility in the application of methods, it clearly favors transaction-based methods. 50 The report takes the position that transaction-based methods are the "most direct means" of

39. Id.
40. Id.
41. Id. at 325 para. 32.
42. OCED Report, supra note 5, at 325 para. 32.
43. Id. at 326 para. 36.
44. Id.
45. Id. at 339 para. 100.
46. Id. at 338 para. 100.
47. OCED Report, supra note 5, at 339 para. 101.
48. Id. at 342 para. 115.
49. Id. at 342 para. 116.
50. Id. at 336 para. 85.
establishing an arm's length price. Therefore, transaction-based methods should be used where they can be "reliably applied." The report states that the CUP method is "preferable over all methods" where it is applicable. The CUP method applies where controlled and uncontrolled transactions are identical or where "reasonably accurate adjustments" can eliminate differences.

3. Other Methods

If a transaction-based method is inapplicable, then other methods may be used as a "last resort." These other methods include the profit-split method, the comparable profits method (CPM), or multiple methods. Under the profit-split method, the associated enterprise strives to achieve the same profit an uncontrolled enterprise would have achieved. The report suggests a profit-split arm's length price can be achieved using a contribution analysis, a residual analysis, or any other appropriate method.

A contribution analysis divides profits among members of the controlled group in relation to the value of their functions performed. In contrast, a residual analysis has two steps. First, the controlled group is allocated a profit based on a comparable uncontrolled basic rate of return. Second, the profit remaining after the first stage is further allocated among the controlled group in a way an uncontrolled enterprise distributes profits. Finally, the CPM compares the operating profits of a comparable uncontrolled enterprise. Comparability of operating profits is essential under the CPM.

The draft report acknowledges serious difficulties in applying profit methods. For example, profit methods may be applied where comparable uncontrolled data is unavailable, or uncontrolled transactions

51. Id. at 345 para. 128.
52. OECD Report, supra note 5, at 345 para. 128.
53. See id. at 336 para. 84-86, 337 para. 93.
54. Id. at 337 para. 93.
55. Id. at 352 para. 172.
56. Id. at 345 para. 128-29.
57. OECD Report, supra note 5, at 347 para. 140.
58. Id. at 347 para. 142.
59. Id. at 353 para. 143.
60. Id. at 348 para. 146.
61. Id.
63. Id.
cannot be reasonably adjusted. Also, profit methods reach an arm’s length result “only on a case-by-case basis.” Nevertheless, the report maintains that profit methods are consistent with realizing the arm’s length principle. However, the report strongly discourages the use of profit methods and urges “considerable caution” when using them.

C. The United States Treasury Regulations Under Section 482

The United States Treasury regulations on transfer pricing are consistent with the OECD draft report in that the standard for allocation of income among commonly controlled enterprises under section 482 remains “that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.” The final Treasury regulations come after a series of proposed and temporary regulations issued in order to implement the “commensurate with income” standard for the transfer of intangible property enacted in the 1986 Tax Reform Act and generally to improve the application of transfer pricing rules.

1. Methods

The regulations include six methods for estimating the arm’s length price for the transfer of tangible property: CUP, RPM, cost-plus, CPM, profit-split, and any unspecified method. There are four methods for estimating the arm’s length price for the transfer of intangible property under the regulations: the comparable uncontrolled transaction method (CUTM), CPM, profit-split, and any unspecified method. All the specified methods are described generally in the summary of the OECD draft report except the CUTM. The CUTM estimates the arm’s length

64. Id.
65. Id. at 353 para. 177.
66. Id. at 352 para. 172.
67. OECD Report, supra note 5, at 352 para. 172.
68. Id. at 353 para. 177.
70. I.R.C. § 482 (1986).
71. See Treas. Reg. § 1.482-3(b) (1986) (discussing the rules relating to the CUP); Treas. Reg. § 1.482-3(c) (discussing the rules relating to the RPM); Treas. Reg. § 1.482-3(d) (discussing the rules relating to the cost plus method); Treas. Reg. § 1.482-6(c)(2) (describing the comparable profit-split method and its application).
72. See discussion supra parts III.B2, B3. Treas. Reg. § 1.482-3(c) (setting forth the rules relating to the CUTM).
price from the price charged in comparable uncontrolled transactions involving comparable intangibles.\textsuperscript{73}

2. The Best Method Rule

The regulations adopt the "best method" rule for selecting a method to determine the arm's length price.\textsuperscript{74} The best method is the "most reliable" method under the facts and circumstances.\textsuperscript{75} The regulations require the taxpayer to document why a particular method is the best among the alternative methods.\textsuperscript{76} Although the best method rule does not prioritize methods,\textsuperscript{77} the regulations implicitly favor the CUP method and the CUTM because they yield the most reliable results if sufficient data is available. In this way, the final regulations reflect the OECD's position that transaction-based methods should be used where they can be "reliably applied."\textsuperscript{78}

However, inquiry into the transfer price methods that have been applied in the United States reveal that methods classified by the OECD as non-transaction-based were used in more than one-third of all transfer pricing cases.\textsuperscript{79} This data reflects the increasing complexity of MNE group transactions and the difficulty in finding reliable comparable transactions for the section 482 methods.

3. Advance Pricing Agreements

In response, MNE groups are increasingly requesting advanced pricing agreements (APAs) to resolve potential transfer pricing disputes.\textsuperscript{80} An APA is a negotiated agreement between tax administrators and the taxpayer. It establishes a transfer pricing methodology to be applied to an

\textsuperscript{73} Treas. Reg. § 1.482-3(c).
\textsuperscript{74} Treas. Reg. § 1.482-1(b)(1).
\textsuperscript{75} Id.
\textsuperscript{76} Treas. Reg. § 1.482-1(c)(1).
\textsuperscript{77} Priorities were a large part of previous regulations and generated a lot of controversy.
\textsuperscript{78} OECD Report, supra note 5, at 345 para. 128.
\textsuperscript{79} Becker, supra note 17, at 361.
\textsuperscript{80} Conclusion of an APA usually precludes a Section 482 audit which can result in penalties and double taxation to the taxpayer. Susan Borkowski, Advance Pricing Agreements and Other Alternatives for Multinational Corporations, 19 INT'L TAX J. 1 (1993). Robert Ackerman, an IRS director of the APA program, reports that seventy taxpayers are formally in the APA program. David Brunori estimates that "approximately 15 taxpayers are entering the program every quarter." David Brunori, Advance Pricing Agreement Program Gets High Marks, 1994 TAX NOTES INT'L 972, Apr. 11, 1994, available in LEXIS, Taxana Library, TNI File.
allocation of income among associated enterprises in advance of the transaction.\textsuperscript{81}

In October, the United States, Canada, Australia, and Japan agreed to common procedures for bilateral APAs.\textsuperscript{82} The common procedures follow the OECD guidelines for transfer pricing methods.\textsuperscript{83} Claude Lemelin, chief of Revenue Canada's transfer pricing section, expects the OECD to include APA procedures in its final transfer pricing report.\textsuperscript{84}

\textbf{D. Steps Toward Global Formulary Apportionment}

Although the OECD draft report and the United States Treasury regulations on transfer pricing suggest broad international support for the arm's length principle, proponents of formulary apportionment have taken significant steps in the United States.\textsuperscript{85} The United States Senate adopted a Sense of the Senate non-binding resolution recommending the use of formulary apportionment in certain cases.\textsuperscript{86} In addition, Senator Byron L. Dorgan, a Democrat from North Dakota,\textsuperscript{87} has "strongly urge[d]" the Treasury Department to reject the OECD draft report on transfer pricing because the arm's length standard has contributed to "massive tax avoidance" by MNE groups in the United States.\textsuperscript{88} The last time the Treasury spoke on the issue of transfer pricing methods in 1993, it took the position that Article 9 of the United States and OECD model treaties

\textsuperscript{81} Notice 94-40, 1994-17 I.R.B. 1.
\textsuperscript{82} Id.
\textsuperscript{84} Id.
\textsuperscript{87} Id. Senator Dorgan served as North Dakota's State Tax Commissioner for over twenty years. North Dakota is a unitary tax state. After twelve years in the United States House of Representatives he was elected to the United States Senate in 1992. He is a member of the Commerce Committee, the Joint Economic Committee and others.
prevent the United States from using formulary apportionment. But, Senator Dorgan said he will attempt to block proposed tax treaties with Sweden, France, and Canada if the Treasury maintains this position. Senator Dorgan also said he will reintroduce his Foreign Tax Compliance Act with a sense of the Congress Resolution supporting the use of unitary methods.

IV. CONVENTIONAL ARGUMENTS

Helmut Becker, a partner in Deloitte & Touche Germany, said, "[The new OECD report . . . clearly states that Global [formulary apportionment] Methods are not in accordance with the arm's length principle (No. 179 through 194). There is nothing more to say.]" Is Helmut Becker right? Part IV of this comment reviews arguments for and against the use of the arm's length principle and global formulary apportionment.

A. Criticism of the Arm's Length Principle

1. Theoretical Arguments

The arm's length principle has been criticized for theoretical, empirical, and administrative reasons. The OECD's draft report acknowledges that the arm's length principle is perceived as "inherently flawed" because it does not account for the economic realities created by associated enterprises. The separate entity approach fails to consider factors like economies of scale and synergistic operations.

In addition, Michael J. McIntyre, professor of law at Wayne State University, disputes the OECD's claim that the arm's length principle achieves tax parity for all transactions among controlled and uncontrolled enterprises. He uses the principle of horizontal equity to show that the arm's length standard does not always achieve this measure of tax fairness. Horizontal equity is advanced where an income tax system

89. John Turro, United States Opponents of Arm's Length Keep Formulary Apportionment Alive, TAX NOTES INT'L, available in LEXIS, Taxana Library, TNI File, 9 TNI 1883 [hereinafter "Keep Formulary Apportionment Alive"].
90. Id.
91. Id.
92. Becker, supra note 17, at 361.
95. Id.
"imposes equal tax burdens on . . . taxpayers who have equal amounts of income."  

According to McIntyre, the arm's length principle would advance horizontal equity if two conditions are met. First, there must be a reasonably reliable and comparable uncontrolled market price. Second, the income earned from a series of controlled group transactions must equal the income earned from a series of comparable uncontrolled group transactions. If these conditions are not met, then there is no basis to determine if horizontal equity is achieved because the taxpayers do not have equal amounts of income. 

McIntyre asserts that the arm's length principle does not meet the first condition because of the nature of the marketplace. A market price is the outcome of unique negotiations. It may be possible to know the price range, but it is impossible to know the actual market price unless a market transaction occurs. As the price range narrows, there is a greater probability that the arm's length price will approximate the market price. The arm's length principle will generally fail to achieve a comparable market price for "intangible" transactions because they are unique. The unique nature of these transactions creates a wide price range which makes the market price uncertain. On the other hand, the arm's length principle will generally achieve a comparable market price for "commodity-type" transactions because they are standard. The standard nature of these transactions creates a narrow price range which makes the market price more certain. Therefore, the arm's length principle reaches a comparable uncontrolled market price that is reasonably reliable for standard transactions where the price range is narrow and the market price is certain. 

McIntyre asserts that the arm's length principle also does not meet the second condition because of the nature of controlled enterprises. Controlled enterprises create "special" operating advantages which are

96. Id. at 5-32.  
97. Id. at 5-31.  
98. MCINTYRE, supra note 94, at 5-33.  
99. Id.  
100. Id.  
101. Id.  
102. Id.  
103. MCINTYRE, supra note 94.  
104. Id.  
105. Id.
difficult to value.\textsuperscript{106} Again, the arm's length principle generally fails for controlled transactions because the special advantages created by these transactions are unique or immeasurable.\textsuperscript{107} The arm's length principle works best for transactions where the special advantages are minimal or ascertainable.\textsuperscript{108} Therefore, the income earned from a series of transactions by a controlled group will approach the income earned from a series of comparable transactions by an uncontrolled group as the special operating advantages of the controlled enterprises decrease or become measurable. McIntyre implies that the arm's length principle approaches tax parity only for those transactions where it can estimate equal income among taxpayers.\textsuperscript{109}

2. Empirical Arguments

Empirical evidence suggests that the arm's length principle has resulted in the avoidance of United States taxes. Senator Dorgan asserts that IRS studies show that the United States loses at least $2 billion a year through tax evasion under the arm's length principle.\textsuperscript{110} James Wheeler, Professor of Accounting at the University of Michigan, estimated that foreign MNE groups operating in the United States cheat the United States Treasury out of about $30 million tax dollars each year.\textsuperscript{111} He estimated that foreign MNE groups in the 1980s had a rate of return on their pretax United States assets around eight percent, yet their tax reports indicated a rate of return of "slightly more than one half of one percent."\textsuperscript{112} In addition, an empirical study for the years 1977-1982 concluded that United States MNE groups shift income internationally.\textsuperscript{113} The study found "that United States manufacturing firms with subsidiaries in low tax countries have relatively low United States tax payments per dollar of assets or sales. Furthermore, having a subsidiary in a high tax region is associated with higher United States tax payments."\textsuperscript{114} Although changes in transfer pricing rules over the past eight years may have effected tax enforcement efforts, adherence to the arm's length principle has remained constant.

\begin{itemize}
  \item \textsuperscript{106} Id. at 5-34.
  \item \textsuperscript{107} Id. at 5-35.
  \item \textsuperscript{108} MCINTYRE, supra note 94.
  \item \textsuperscript{109} Id.
  \item \textsuperscript{110} Turro, supra note 86, at 2.
  \item \textsuperscript{111} Larry Franko et al., The International Tax Showdown, 20 INT'L TAX J. 1, 12 (1994).
  \item \textsuperscript{112} Id.
  \item \textsuperscript{113} David Harris et al., Income Shifting in US Multinational Corporations, STUD. IN INT'L TAX. 277 (1993).
  \item \textsuperscript{114} Id.
\end{itemize}
3. Practical Arguments

The OECD does not address the issue of tax evasion, but it does admit that application of the arm's length principle can be an overwhelming administrative burden for both the tax administrator and taxpayer.\(^5\) "[Y]ou have to be somewhat of a rocket scientist to figure all [the transfer pricing rules] out," said Kevin Dolan, a partner at Weil, Gotshal & Manges and former IRS Associate Chief Counsel.\(^1\) Senator Dorgan believes that the use of APAs are like "signing a confession that the arm's length approach doesn't work."\(^117\)

MNE groups increasingly engage in transactions for which there are no uncontrolled comparisons.\(^118\) For example, MNE group transactions involve the "integration of highly specialized goods, in unique intangibles, and/or in the provision of specialised services."\(^119\) These types of transactions make application of the arm's length principle difficult.\(^120\)

B. Benefits of the Arm's Length Principle

The OECD responds that the arm's length principle is "sound" in theory because it simulates the workings of the open market.\(^121\) Broad international consensus for the arm's length principle creates a shared understanding for transfer pricing methods and reduces the risk of double taxation.\(^122\) The OECD asserts that the arm's length principle is effective "in the vast majority of cases."\(^123\) It categorically rejects global formulary apportionment as a "realistic alternative to the arm's length principle."\(^124\)

\(^{115}\) OECD Report, supra note 5, at 324 para 28.
\(^{117}\) Turro, supra note 86, at 3.
\(^{118}\) OECD Report, supra note 5, at 324 para. 28.
\(^{119}\) Id. at 324 para. 25.
\(^{120}\) See id. at 325 para. 29.
\(^{121}\) Id. at 325 para.
\(^{122}\) Id. at 325 para. 31.
\(^{123}\) OECD Report, supra note 5, at 324 para 25.
\(^{124}\) Id. at 351 para. 184.
C. Criticism of Global Formulary Apportionment

1. Theoretical Argument

Global formulary apportionment would treat an MNE group engaged in controlled transactions as a single business unit for tax purposes.125 It would allocate the MNE group’s global profits among the associated enterprises in different taxing jurisdictions on the basis of a predetermined formula.126 Global formulary apportionment would require international cooperation in ascertaining the unitary business, determining global profits, and establishing the tax formula.127 The OECD criticizes formulary methods as arbitrary because they allocate profits with no sound relationship to market conditions or the facts surrounding the transaction.128

2. Practical Arguments

Another basic criticism of the unitary approach is that it is a “design for disagreement.”129 Opponents assert that formulary apportionment is a “statutory structure” that has no meaning until all the details are filled in, and it provides no guidance on what the appropriate details should be.130 The OECD warns that reaching international agreement on the details would be “time-consuming and extremely difficult.”131 Implementation of a unitary system “[w]ould present enormous political and administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation.”132 Disagreement between tax administrators and taxpayers could be a problem too. MNE groups could avoid taxes to the extent that components of the formula can be manipulated by shifting the factors of production from high to low tax jurisdictions.133 Also, any new tax rule may contain unforeseen loopholes with the potential for lost tax revenue.134

125. UNITED STATES GENERAL ACCOUNTING OFFICE, supra note 13, at 205.
126. OECD Report, supra note 5, at 353 para. 181.
128. OECD Report, supra note 5, at 354 para. 189.
129. Wilkins, supra note 127, at 4.
130. Id.
132. Id. at 351 para. 187.
133. Id. at 354 para. 188.
134. Wilkins, supra note 127, at 5.
Some experienced tax practitioners believe that existing problems with formulary apportionment at the state level in the United States will become exacerbated if it is applied worldwide. Inconsistency flourishes at the state level, despite the relative cultural and political homogeneity of the states, the restrictions imposed by the United States Constitution, and established formal mechanisms devoted to achieving uniformity. A lack of international coordination would increase the risk of double taxation. Also, exchange rate movements would cause wide fluctuations in tax determinations under the unitary approach. Furthermore, the international community’s negative response to the United States Supreme Court’s Barclays Bank decision caution against the use of global formulary apportionment.

D. Benefits of Global Formulary Apportionment

Advocates of the unitary approach argue that global formulary apportionment reflects economic reality by treating MNE groups on a consolidated basis. They believe that the strength of formulary apportionment is that it eliminates many of the problems associated with the arm’s length principle. For example, comparable uncontrolled transactions are unnecessary. Formulary apportionment reduces the administrative burden on taxpayers because only one set of accounts is necessary for tax purposes. It also decreases the uncertainty of an audit and it improves tax compliance. Proponents acknowledge, however, that international cooperation is required for global formulary apportionment to work effectively.

V. UNCONVENTIONAL WISDOM

The preceding discussion reflects the tax community’s conventional wisdom that these two transfer pricing approaches are polar opposites. Part IV of this comment proposes that transfer pricing rules

---

135. Id. at 4.
136. Id.
137. OECD Report, supra note 5, at 351 para. 189. Although the arm’s length principle is not immune to exchange rate movements, it is better able to deal with them because it analyzes the specific facts and circumstances of each taxpayer. Id.
138. Evans, supra note 26, at 3.
139. UNITED STATES GENERAL ACCOUNTING OFFICE, supra note 13, at 205.
140. Id.
141. OECD Report, supra note 5, at 354 para. 183.
142. Turro, supra note 86, at 3.
should reflect rational tax principles rather than labels. The result is a continuum of methods from the CUP method to formulary apportionment.

A. Rational Tax Principles

Charles Adams said, "how we tax and spend determines, to a great extent, whether we are prosperous or poor, free or enslaved, and most important, good or evil." Hence, our tax principles should consider the informed judgements of civilization. In *The Wealth of Nations*, Adam Smith set out four marks of a bad tax system:

(1) A tax was bad that required a large bureaucracy for administration.
(2) A tax was bad that 'may obstruct the industry of the people . . . '.
(3) A tax was bad that encouraged evasion . . . .
(4) A tax is bad that puts people through 'odious examinations of the tax-gatherers, and exposes them to much unnecessary trouble, vexation, and oppression . . . .'  

Section 482 resembles the four marks of a bad tax system. First, Frank Ng, Chief of the IRS Tax Treaty Division, described the IRS's international enforcement staff as "large" compared to the treaty partners of the United States. Second, Michael Patton, a partner at Ernst & Young, estimated that over half the cases pending in the United States Tax Court involve transfer pricing issues. Third, much of the transfer pricing debate on Capitol Hill has been stimulated by concerns over tax evasion. Fourth, an audit exposes the taxpayer to penalties and double taxation. This comparison does not imply that formulary apportionment is good and the arm's length principle is evil. Instead, Adam Smith's observation on
taxation suggests that it is important to reflect on what is good and bad about transfer pricing rules.149

B. A Good Tax Gone Bad

1. The Arm’s Length Principle

The arm’s length principle is a good tax gone bad. The OECD maintains that “the arm’s length principle has . . . [b]een found to work effectively in the vast majority of cases.”150 The arm’s length standard works best for transactions where there is a reasonably reliable comparable uncontrolled transaction and a transaction-based method can be used.151 In the vast majority of cases, the arm’s length principle is a good tax. Problems with the arm’s length principle increase as comparability becomes strained.152 The arguments against the arm’s length principle are pointedly applicable where controlled transactions lose comparability with uncontrolled transactions.

Michael Patton described the difficulty in applying non-transaction-based methods to a controlled transaction where comparable data is insufficient or nonexistent.153 "It’s kind of like trying to determine how many angels could dance on the head of that pin if there really were angels that could dance on the heads of pins."154 In these cases, the arm’s length principle is a bad tax.

2. Advance Pricing Agreements

The tax community’s response to the ineffectiveness of the arm’s length principle is the APA.155 However, APAs have some of Adam Smith’s marks of a bad tax system too. Although APA’s probably do not encourage tax evasion, they enlarge the tax bureaucracy. APAs are a second tier in the IRS’s enforcement brigade. They are also a quasi-audit for the taxpayer requiring time and expense that “obstruct[s] the industry of the people.”156 Additionally, an APA exposes the taxpayer to “much unnecessary trouble” where formulary apportionment is a less restrictive

149. ADAMS, supra note 1.
150. OECD Report, supra note 5, at 324 para. 25.
151. See discussion supra part II.B.2.
152. See discussion supra part III.A.
153. Franko, supra note 111, at 5.
154. Id.
155. See discussion supra part I.C.3.
156. ADAMS, supra note 1, at 286.
alternative. APAs move transfer pricing rules from worse to bad. APAs are the modern version of the tax enforcement measures Imperial Spain enacted in the face of massive tax avoidance. Spain's "crackdown was about as effective as putting gasoline on a smoldering fire."

C. Global Formulary Apportionment as an Alternative to the Arm's Length Standard

Global formulary apportionment is a realistic alternative to the arm's length principle for appropriate transactions. MNE groups which create knowledge and information that add value to our society face transfer pricing issues that preclude arm's length comparability. The OECD acknowledges that MNE groups are increasingly engaged in transactions where they are involved in the "integration of highly specialized goods, in unique intangibles, and/or in the provision of specialised services." Transaction-based methods are unworkable for these types of transactions, yet profit and other methods are often just as difficult. The pitfalls of the arm's length standard begin when a controlled transaction loses comparability with uncontrolled transactions. For example, the arm's length standard retreats from tax parity. Administrative burdens increase for both the tax administrator and taxpayer. There is less certainty about the appropriate transfer price methodology. There is also greater exposure to the risk of audit and double taxation. As a result, an APA is likely.

Even though the OECD and section 482 recognize the limitations of the arm's length principle for certain transactions, both sets of rules rely on alternatives that emphasize labels over rational tax principles. Some practitioners contend that profit methods have diluted the arm's length principle to the extent that the international consensus for the arm's length

157. Id.
158. Id. at 197.
159. See discussion supra part III.D.
160. OECD Report, supra note 5, at 324 para. 25; see also discussion infra part II.A.3.
161. See discussion supra part III.B.3.
162. See discussion supra part III.A.1.
163. See discussion supra part III.A.3.
164. Id.
165. The OECD expressly disparages profit methods. Section 482 implicitly favors the CUP method and the CUTM over profit methods. Yet, both the OECD and the United States Treasury categorically reject alternative global formulary methods. See discussion supra parts III.B.3., C.2.
principle is only "superficial." The OECD and United States Treasury's rejection of the unitary approach is formulative and dogmatic.

Global formulary apportionment eliminates many of the problems associated with the arm's length principle. Comparable uncontrolled transactions are unnecessary for formulary apportionment. Administrative burdens, uncertainty, and tax evasion can be reduced by the unitary approach. Also, the risk of double taxation under formulary apportionment is no greater than the risk of double taxation under the arm's length principle. Global formulary apportionment should be an alternative method for transactions where it advances rational tax principles.

D. A Continuum of Transfer Pricing Methods

Transfer pricing rules should be a continuum of methods from the CUP method to formulary apportionment. One end of the spectrum should continue to emphasize transaction-based methods for the vast majority of cases. The other end of the spectrum should use a global formulary method for transactions that fail to meet an acceptable level of comparability with uncontrolled transactions. The OECD should take the position that there are several transfer pricing methods with strengths and weaknesses for different transactions. It should also define acceptable levels of comparability for particular methods. The OECD should outline the components of a global formulary method for transactions that cannot be reliably compared to uncontrolled data. In addition, the OECD should define global formula for various industries and provide the framework for international consensus for creating global formulary methods.

While the transfer pricing continuum resolves some issues, it raises others. The task of achieving international consensus and uniform application of a global formulary method will be formidable, but formidability is not new to the present transfer pricing system. International cooperation on these issues is in the self-interest of nations. Arnold Weiss and Ferenc Molnar, and members of Arent, Fox, Kintner, Plotkin & Kahn, warn that "[w]ithout a measure of uniformity and predictability in the tax treatment of international operations, such operations will fail to achieve their maximum potential, and to a parallel extent, the

166. Turro, supra note 86, at 5.
167. See discussion supra part III.B.3., C.1.
168. Barclays Bank v. Franchise Board of California, 114 S.Ct. at 2279; see also supra part I.A.
169. WEISS & MOLNAR, supra note 6, at 108.
potential prosperity of nations will be tempered." The United States Treasury should pioneer regulations that define the transfer pricing continuum and global formulary methods. The United States should take the leadership role in the OECD to promote international cooperation toward "uniformity and predictability" for international transfer pricing rules.

VI. CONCLUSION

The primary goal of the transfer pricing continuum is to interject rational tax principles into the international transfer pricing debate. Rational tax principles suggest a more pragmatic approach to resolving transfer pricing issues. Debate on these issues should be guided by our shared understanding for good tax principles, rather than the present conventional wisdom of the tax community.

Athens, the largest and most powerful city in ancient Greece, was the chief administrator of the Delian League. The League was a defense alliance to which weak cities paid a compulsory tribute tax in exchange for protection. Aristides the Just was the League's first tax assessor. The biographer Plutarch, described Aristides taxes:

[H]e drew up the list of assessments not only with scrupulous integrity and justice but also in such a way that all states felt they had been justly and fairly taxed. . . . [The cities] desired Aristides of the Athenian and gave him command, surveying the country and revenue, to assess everyone according to ability and worth. . . .

The time of Aristides was a "golden age" for Athens and its allies. If we too are to experience a golden age, then our tax systems must be just for both tax administrators and taxpayers.

170. Id.
171. Id.
172. ADAMS, supra note 1, at 55. The Delian League's name was changed to the Athenian League when the Treasury moved to the Parthenon in Athens. Id. at 62.
173. Id. at 55.
174. Id. at 50.
175. Id. at 57 (quoting Plutarch).
176. ADAMS, supra note 1, at 57.
The Riess Institute
9555 Friendship Station
Washington, DC 20016
Telephone/Telecopier (Fax): (202) 966-6501
e-mail: eghbal@riess.org InterNet: http://www.riess.org

Peter Britton, Chairman
Christopher Bird, Vice-Chairman
Morad Eghbal, Secretary-Treasurer

HONORARY CHAIRMAN
Stephan Riess (1983-85)
Adolph Schoepe (1987-

MISSION STATEMENT
The Riess Institute exists to provide deep-seated potable water for both people and agriculture.

Crystalline rock and its intersecting fracture zones have been found to contain large volumes of deep-seated water which, more often than not, is of potable quality. Using knowledge of mineralogy, petrology and structural geology, the Riess Institute has developed an approach for identifying and exploring ancient hydrothermal systems as a potable water resource. Often found in arid areas, devoid of sufficient rainfall to account for the quantities of water encountered, these natural conduits have replenished water when other sources have failed.

THE RIESS INSTITUTE TODAY
The Riess Institute established in 1983 as the Riess Foundation, is a non-profit, public Institute with a 501(c)(3) classification as granted by the United States Internal Revenue Service.

Historically, all water is believed to come only from the hydrologic cycle. Yet, a growing body of evidence being developed by The Riess Institute, and others in the past, suggests that water might be generated deep within the earth in vast and inexhaustible quantities.

What distinguishes The Riess Institute from any other water research entity in the world today is our goal to identify how the dynamics of "new" water generation deep within the earth’s interior, which when rising to the surface appears to become a veritable addition to the earth’s hydrosphere. This vertical component of our focus is also linked to substantiating and correlating the horizontal component of water distribution (i.e., hydrologic cycle and theories of watersheds) in this evolving model. In this endeavor, we are on the verge of major breakthroughs in water signatures, which would tend to identify a possible, different source of waters originating from deep within the earth.

FUNDING SUPPORT AND ADDITIONAL INFORMATION
The Riess Institute derives its funding principally from the generous support of individual contributions and revenues generated by service contracts in locating drilling sites for new sources of water for municipalities or commercial use.

We welcome all inquiries as to our work or how we may help in locating and drilling for deep-seated new water sources throughout the world. We are especially interested in inquiries from those areas of the world that are experiencing critical water shortages, now or anticipate water shortages in the future.

We also welcome any and all contributions. Your contributions are fully deductible from federal income taxes.

Please address any inquiries or contributions to the attention of Mr. John Sweeney.