Annual Survey of International & Comparative Law

Volume 3 | Issue 1 Article 8

1996

Transfer Pricing Solutions in the Global Economy

Sandra Reid Robertson

TRANSFER PRICING SOLUTIONS IN THE GLOBAL ECONOMY*

SANDRA REID ROBERTSON**

I. INTRODUCTION

As the world marches at a furious pace toward a truly global economy, the issues inherent in establishing transfer pricing across international borders and the related international tax consequences of those transactions become more important. Corporations continue to diversify and become multinational and existing multinational companies expand their holdings; consequently, the "opportunities" for double taxation increase.[1] Double taxation occurs when two or more countries tax the same income.[2] When discrepancy exists as to which of two related companies has earned taxable income, both countries may tax the same income. Multinational companies often attempt to minimize their global tax burdens by "setting" prices for goods and services which reduce the target government's tax base.[3] Taxing jurisdictions are losing tremendous amounts of revenue because of corporate manipulation of transfer pricing.[4] Some economists even suggest that the ability to manipu-

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* Edited by Pamela K. Kayfetz, J.D. 1994, LL.M. (Tax) 1995, LL.M. (International Legal Studies) 1996, Golden Gate University School of Law; M.B.A. (International Business) 1985, Monterrey Institute of International Studies. *Editorial Staff*: Leenar Liew, J.D. 1999, and Yasmin Zarabi, J.D. 1998, both attending Golden Gate University School of Law.

** J.D. 1996, Baylor University School of Law; B.A., University of Florida. The author has been involved in tax law for more than 20 years, first as an appeals officer for the U.S. Internal Revenue Service and now with specialization in the international aspects of tax.

1. Robert G. Clark, *Transfer Pricing, Section 482, and International Tax Conflict: Getting Harmonized Income Allocation Measures from Multinational Cacophony*, 42 AM. U. L. REV. 1155, 1157 (1993).

2. *Id.*.

3. Richard L. Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299, 300.

4. Charles F. Connolly, *Comment, The New Transfer Pricing and Penalty Reg-*

late transfer prices is a major reason for the existence of multinational enterprises.[5]

Transfer pricing adjustments can be made by tax authorities when they disagree with income allocations between two or more related entities, as is often the issue in component pricing situations.[6] However, countries must balance the considerations of protecting their domestic tax base with the interests of their citizens in avoiding double taxation. Attempts to correct inequities and abuse in one area, such as tax base erosion, can have the collateral consequence of double taxation of domestic entities. In other words, if the United States, for example, takes an aggressive posture in transfer pricing issues relative to a United States subsidiary of a foreign parent, it is simultaneously subjecting that domestic subsidiary to potential double taxation.

The world community has attempted to eliminate double taxation, primarily through tax exemptions and tax credits, where in one form or another an entity is "given credit" for tax paid in a foreign jurisdiction on certain income.[7] In addition, tax treaties between specific countries attempt to address and eliminate double taxation. However, certain gaps exist and impasses are encountered even with a valid treaty procedure.[8] All United States tax treaties, except the one with Ireland, contain competent authority[9] procedures.[10] These procedures

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ulations: Increased Compliance, Increased Burdens, and the Search for a Safe Harbor, 16 U. PA. J. INT'L BUS. L. 339, 341 (1995).

5. Roger Gordon & Jeffrey Jackie-Mason, *Why Is There Corporate Taxation in a Small Open Economy? The Rule of Transfer Pricing and Income Shifting* (National Bureau of Economic Research Working Paper No. 4690, 1994).

6. Clark, *supra* note 1, at 1157.

7. OECD Report on Fiscal Affairs and Multinational Enterprises 7 (1979) [hereinafter OECD Report]. The Organization for Economic Cooperation & Development [hereinafter OECD] defines double taxation as: "inclusion of the same income in the tax base by more than one tax administration." OECD Report, *supra*.

8. *See* James R. Mogle, *Competent Authority Procedure*, 23 GEO. WASH. J. INT'L L. & ECON. 725, 725 (1990).

9. The term "competent authority" has two meanings when used in this context. It means both the jurisdiction and legal authority to deal with a particular problem and the person ("Competent Authority") in a particular jurisdiction vested with the power to effect the competent authority process. This author will address both the person ("Competent Authority") and the competent authority process and make every attempt not to confuse the reader.

10. Michael G. Brandt & Mark H. French, *Revised Competent Authority Pro-*

provide a means of contesting actions by one of the treaty partners which would result in taxation not in accord with the treaty provisions.[11] The competent authority procedures are time-consuming, cumbersome, and many times avoided by taxpayers truly in need of relief of double taxation.[12] This paper will provide a brief history of the problems which transfer pricing issues have caused for both international companies and taxing jurisdictions. It will also examine efforts by the United States tax system to remedy this two-sided problem. The United States has primarily attempted to deal with the problem from its fiscal perspective, the underpayment of United States income tax by foreign companies through transfer pricing abuse. The double taxation problem for taxpayers has an effective, albeit cumbersome, solution in the competent authority process. However, the very fact that double taxation problems still exist, suggests the need for more effective dispute resolution methods between the taxing jurisdictions and the related taxpayers, whether it be the existing competent authority procedure or new methods. Potential long term solutions to these transfer pricing problems will also be examined.

II. THE TRANSFER PRICING DILEMMA

Transfer pricing manipulation often results in income which is taxable under United States law escaping U.S. taxation. Unrelated companies dealing "at arm's length" set their

cedures Expand Availability but More Guidance is Needed, 83 J. TAX'N 223, 223 (1995) (Competent authority procedures are mutual agreement procedure articles of treaties that provide means of resolving disputes that would result in taxation not in accordance with the treaty, *i.e.* double taxation. The treaties allow the taxpayer to present its case to the Competent Authority of the country of residence. If the resident's Competent Authority believes the allegation is justified and cannot resolve the case, it may present the case to the Competent Authority of the treaty partner. The two Competent Authorities will then attempt to resolve the dispute.).

11. Dianne K. Kanakis, *International Tax Planning for the U.S. Multinational Corporation - Competent Authority,* 270 PRACTICING LAW INSTITUTE, TAX SERIES 339, 339 (1988) (Since 1971 cases processed through the Competent Authority total approximately 1,100. Over 900 of those cases have been closed. Despite difficulties in negotiating across international boundaries, over 70 percent of the cases closed received partial or full relief from double taxation. Competent Authority cases in the United States as of 6/30/87 approximated 260. Over 83 percent of these were allocation cases.)

12. *Id.*.

prices in accordance with market forces,[13] causing tax liabilities to fall naturally in the appropriate jurisdictions. Conversely, since related companies have no such need to compete with each other, they can set pricing levels between themselves to minimize their overall tax burden.[14] Depending on the location of a tax haven jurisdiction, as well as any concerns companies may have regarding their domestic tax base(s), companies can manipulate transfer prices to their overall benefit. For instance, a company that benefits, overall, from the increased profitability of a subsidiary does not have any incentive to charge that subsidiary a fair "arm's length price"[15] for the goods or services sold. Internal Revenue data show that in 1986 foreign-owned business in the United States had gross income in excess of $500 billion and reported aggregate tax liability of *negative* $1 billion.[16]

One situation where transfer pricing can be improperly used to reduce overall tax payments by related companies is the hypothetical case of a foreign parent corporation which maintains a wholly owned manufacturing subsidiary located in the United States and supplies that subsidiary with component parts to assemble the final product.[17] If the parent is located in a more favorable tax jurisdiction, then it can reduce its overall tax burden by manipulating the price it charges the subsidiary for the component parts. The parent can virtually avoid or evade any tax liability in the United States by setting the component price it charges the subsidiary so high that the subsidiary, despite its productivity, can do no better (at least for U.S. tax base purposes) thàn break even. With little or no

13. Clark, *supra* note 1, at 1160.

14. MERTENS LAW OF FED. INCOME TAX'N § 45I.01 (1995) [hereinafter MERTENS] (Tax considerations which might influence a controlled group's incentive to shift income away from or to a particular jurisdiction include effective tax rates, availability of tax holidays, timing considerations which might allow significant deferral of income, effectiveness of tax administration and enforcement in the jurisdiction, and withholding rates applicable to distributions of earnings or royalties).

15. Clark, *supra* note 1, at 1164-66.

16. 136 CONG. REC. H928 (daily ed. Mar. 20, 1990) (remarks of Rep. Dan Rostenkowski, Chairman of the House Ways and Means Committee, upon introduction of The Foreign Tax Equity Act of 1990); *see also* Daily Tax Rep. (BNA), Feb. 14, 1990, at G-2 (foreign-owned car makers paid federal income tax of .00166% of United States assets).

17. Clark, *supra* note 1, at 1164.

taxable income in the United States, the subsidiary pays little or no U.S. tax, even though true value was added in the United States and income tax liability should be paid in this jurisdiction.[18]

The repatriation of income to a foreign parent is only one of three facets of the transfer pricing problem.[19] The manipulation of transfer pricing also causes problems in expatriation of income to a foreign affiliate, and two-way transfers of intangible property.[20] This article emphasizes the repatriation of income perspective.

III. PAST U.S. ENDEAVORS TO ADDRESS THE TRANSFER PRICING PROBLEM

The Commissioner of Internal Revenue has had the authority to allocate income and deductions among affiliated entities since 1917.[21] The 1928 Revenue Act significantly expanded this reallocation power to determine the related entities' "true tax liability."[22] The United States' primary administrative tool in addressing transfer pricing issues, in relation to both international and domestic transactions, is Internal Revenue Code § 482.[23] This broad section permits the Internal Revenue Service (hereinafter I.R.S. or Service) to reallocate income and deductions between and among entities which are controlled either directly or indirectly by the same interests, if this allocation is necessary to prevent evasion of tax or to reflect clearly the true income of the entities.[24]

The Commissioner increased efforts under § 482 in the foreign arena beginning in 1960 with the adoption of an accelerated International Enforcement Program to scrutinize ar-

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18. *Id.* at 1165.
19. *Id.* at 1164.
20. *Id.* at 1165.
21. Regulation 41, Articles 77-78, War Revenue Act of 1917, Ch. 63, 40 Stat. 300 (1917).
22. H.R. Rep. No. 2, 70th Cong., 1st Sess. 16-17 (1928).
23. I.R.C. § 482 (West 1996) [hereinafter I.R.C. § 482].
24. Treas. Reg. § 1.482-1(a)(1) as amended in 1994 reads: "The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions."

rangements between U.S. taxpayers and their related foreign entities.[25]

Historically, the Internal Revenue Service has encountered substantial difficulties in reallocating income under § 482.[26] Evidentiary problems abound.[27] As foreign multinationals have become more sophisticated in setting transfer prices and disguising controlled entities, the efforts by the I.R.S. and Congress have intensified.

In the early 1960's, the United States officially adopted the traditional arm's length standard approach in dealing with transfer pricing issues and persuaded the rest of the world to follow.[28] In 1979, the Organization for Economic Cooperation & Development Committee, the United Nations, and the United States adopted model conventions addressing transfer pricing adjustments and the use of the arm's length standard.[29] None of these model conventions, however, provides the methods for determining the arm's length price. The factual determination of an arm's length price is, of course, essential if proper allocation adjustments are to be made. The difficulty of determining an arm's length price is one of the principal reasons for the complexities of identifying and correcting abuses in transfer pricing.

Increased concern for tax base losses prompted Congress to revisit the transfer pricing issue in the Tax Reform Act of 1986,[30] and to begin to address the problems related to transfers of intangible assets. Recent efforts in the transfer pricing

25. MERTENS, *supra* note 14, at § 451.45.

26. The OECD recognizes that "in many cases, there may be a genuine difficulty in accurately determining (an arm's length) price." *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Discussion Draft, Part I*, 94 TAX NOTES TODAY 133-38, July 11, 1994, ¶18.

27. *Roundtable Discussion in International Taxation with D. Kevin Dolan, Steven E. Shay, and David R. Tillinghast*, 61 TAX NOTES 1119, 1121 (1993).

28. Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation,* 15 VA. TAX REV. 89, 90 (1995).

29. ORGANIZATION FOR ECONOMIC COOPERATION & DEVELOPMENT COMM. ON FISCAL AFFAIRS, TRANSFER PRICING AND MULTINATIONAL ENTERPRISES 7 (1979).

30. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231 (c)(1), 100 Stat. 2085, 2562-63 (*codified at* 26 U.S.C. § 482 (1988)).

area, including the White Paper and the Advance Pricing Procedures, will be discussed later in some detail.

IV. CURRENT U.S. LAW

I.R.C. § 482 provides that:

> In any case of 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 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. In the case of any transfer (or license) of intangible property, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.[31]

This deceptively simple Code section is particularly difficult to administer. The I.R.S. must determine that a sufficient relationship exists between two entities to subject them to the provisions of § 482. Companies which are owned directly or indirectly by the same interests are subject to the provisions of § 482.[32] Ownership is primarily a factual determination and thus easier to ascertain than the accompanying provision of § 482 which provides the power for the I.R.S. to reallocate income between and among companies which are "controlled," either directly or indirectly, by the same interest. The regulations provide that "control" includes any kind of control, whether legally enforceable and however exercised.[33] It is the reality of the control which is decisive, not the form.[34] More-

31. I.R.C. § 482.

32. *Id.*.

33. Treas. Reg. § 1.482-1(a)(3) (1995).

34. Treas. Reg. § 1.481-1(b)(1), as amended in 1994 reads: "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 an uncontrolled taxpayer."

over, a presumption of control arises if income or deductions have been arbitrarily shifted.[35] Certain foreign corporate structures may exhibit the requisite control but, because of difficulties in getting sufficient evidence to establish such control, escape domestic taxation and attempts made under § 482 to reallocate income.

In order to raise a § 482 issue and prevail in potential litigation, the Service must know:

1. The details of the questioned transactions as they actually happened;

2. The functions which were performed to accomplish the transactions;

3. Which organization performed each function (functional analysis); and

4. The method or basis upon which the intercompany charge was made, or not made, by the taxpayer.[36]

If the Service believes it has sufficient evidence to propose an adjustment authorized by I.R.C. § 482, the Service may assign a "price," used only for allocating taxable income, that would reflect what the same transferor would have charged an unrelated third party. The Internal Revenue Regulations regarding I.R.C. § 482 state that the purpose of § 482 is to place a "controlled taxpayer on a tax parity with an uncontrolled taxpayer."[37] This regulation further provides that the standard to be applied in seeking such parity is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.[38] Although the regulations provide for several methods of determining an arm's length price for purposes of reallocating in-

35. The final regulations offer more guidance and flexibility than the earlier temporary regulations. *See* Robert D. Hasley, Jr., *U.S. Sets New Tax Rules on Pricing*, N.Y. TIMES, July 5, 1994, at D3.

36. MERTENS, *supra* note 14.

37. Treas. Reg. § 1.482-1(a)(1) (*as amended by* T.D. 8552, 59 Fed. Reg. 34,971, (July 8, 1994)).

38. Treas. Reg. § 1.482-1(b).

come, all are problematic.[39] Since the three traditional arm's length pricing methods have been ineffective in numerous cases, the courts have come to rely on "fourth methods," a labor-intensive, case-by-case basis.[40]

V. RECENT U.S. EFFORTS TO SOLVE TRANSFER PRICING ISSUES

The Tax Reform Act of 1986 initiated the most recent efforts to deal with transfer pricing issues. The addition of the last sentence of § 482 signals the new emphasis on the particular problems associated with intangibles in transfer pricing; it provides that the income attributable to an intangible asset shall be determined in a manner that is "commensurate with the income" from that asset. The traditional arm's length standard attempts to correct the problem on a case-by-case basis. The commensurate with income standard goes to the root of the problem in reallocating the income retrospectively.[41] It signals a new direction in chasing the tax dollars attributable to transfer pricing manipulation.

In acknowledging both the inherent problems in transfer pricing and the particular problem with intangible assets, the Internal Revenue Service conducted an intensive study of transfer pricing issues. The results of this study are known as the "White Paper."[42] The Service interviewed its International Examiners to determine what difficulties they were encountering in administering the law. This study concluded that the International Examiners had significant problems obtaining access to relevant information to make pricing determinations.[43] Most taxpayers were unable to or simply did not provide the information necessary to determine how their intercompany pricing was established. Although administrative summons and formal document request procedures are available to examiners in attempting to obtain the necessary infor-

39. Clark, *supra* note 1, at 1169 (The principal pricing methods that are used are the comparable uncontrolled price, resale price, and cost plus methods.).

40. *Id.* at 1174.

41. *Id.* at 1179.

42. *A Study of Intercompany Pricing Under Section 482 of the Code*, I.R.S. Notice 88-123, 1988-2 C.B. 458, 459.

43. *Id.* at 461.

mation from foreign taxpayers, for numerous reasons these tools have not produced the required evidence. As one result of the White Paper, Congress enacted stringent penalties to aid in the enforcement of the law.[44]

One significant attempt to solve the transfer pricing issue, which arose as a result of the White Paper, was the advent of Advance Pricing Agreements, or A.P.A.s.[45] In 1991, the Service proposed an advance pricing procedure[46] whereby the taxpayer can suggest a transfer pricing method in advance, and if the Service agrees, the taxpayer can use the method approved for establishing transfer pricing, with no fear of a § 482 adjustment.[47] The A.P.A. is a binding agreement between the taxpayer and the I.R.S.. The competent authorities of the two relevant jurisdictions may enter the proceedings but are not required to do so.[48] The Service hoped that this prospective solution would encourage corporations to obtain A.P.A.s, thus reducing both the Service's and the taxpayer's costs involved in litigating this issue. Reviews as to the A.P.A.'s effectiveness, however, have been mixed.[49]

The A.P.A. procedure is very complicated and costly to the taxpayer.[50] In addition, A.P.A.s are not published and are of no precedential value. These facts lead to the impression that I.R.S. is "cutting deals" with large corporate taxpayers.[51] Despite the cumbersomeness of the process, A.P.A. procedures do

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44. *Transfer Pricing Penalty Documentation Rules Eased for Some Years,* 5 J. INT'L TAX'N 287 (1994) (A 20% substantial valuation misstatement penalty is imposed under § 6662(e)(1)(B) when a transfer price of a related party transaction is 200% or more, or 50% or less, than the correct price determined under § 482. The penalty is 40% for a gross valuation misstatement under § 6662(h)(2), which has thresholds of 400% and 50%.).

45. Avi-Yonah, *supra* note 28, at 154.

46. Rev. Proc. 91-22, 1991-1 I.R.B. 526.

47. *Id.*.

48. *Id.*.

49. *See e.g.*, Peter A. Glicklich & Seth B. Goldstein, *Changes in U.S. Transfer Pricing Regulations Increase Compliance Burdens for Multinationals and Up the Ante in Transfer Pricing Disputes*, 41 CAN. TAX. J. 382, 386 (1993); Steven P. Hannes, *IRS 1994 Transfer Pricing Rules Reward Planning and Documentation, Increase Penalty Risks*, 94 TAX NOTES TODAY, Aug. 1, 1994, available in LEXIS, Fed. Tax Library, TNT File.

50. Avi-Yonah, *supra* note 28, at 154.

51. *Id.* at 155.

hold some long-term hope for providing solutions to the transfer pricing issues, particularly in specific industries. In fact, the major transfer pricing cases probably arise with a limited number of taxpayers. The top 350 multinational corporations control about a third of the world's productive resources.[52] These companies are likely to account for the vast majority of transfer pricing cases in the United States.[53]

VI. DIFFICULTIES IN APPLICATION OF § 482 TO FOREIGN COMPANIES: THE JAPANESE EXAMPLE

In addressing transfer pricing issues, the United States has encountered more problems applying § 482 to companies affiliated with certain foreign jurisdictions than others. The inherent problems in determining the validity of international transfer pricing and in reaching agreeable solutions for all three parties involved have been exacerbated by cultural differences as well.

In contrast to the United States, for example, Japan, despite statutory prohibition, tacitly encourages monopolies in its markets.[54] From an American viewpoint, Japan inadequately enforces anti-monopoly policy particularly in regard to the Japanese corporate phenomenon known as the *keiretsu*.[55]

Each *keiretsu* is an amorphous network of related companies centered around one "parent" company or bank, and essentially monopolizes segments of the Japanese economy.[56] Although one may find traditional corporate ownership or partial ownership occasionally, most members are bound to the *keiretsu* by an "almost transparent interlinking of Japanese companies."[57] This is accomplished by interlocking director-

52. Marc M. Levey, et al., *Japan's Pricing System is Evolving Along U.S. Lines*, 4 J. INT'L TAX'N 407 (1993): "President Clinton's call for additional 235 agents specifically to review transfer prices represents a more explicit example of this intention to reduce transfer pricing abuses." Levey, et al., *supra*, at p. 413

53. Avi-Yonah, *supra* note 28, at 155.

54. Gregory K. Bader, Note, *The Keiretsu Distribution System of Japan: Its Steadfast Existence Despite Heightened Foreign and Domestic Pressure for Dissolution*, 27 CORNELL INT'L L.J. 365, 365 (1994).

55. ELEANOR M. HADLEY, ANTITRUST IN JAPAN 257 (1970).

56. Bader, *supra* note 54, at 366.

57. *Id.* at 372.

ates, presidential councils, group-member shareholding, lending preferences, few intra-group competitors, and intra-group grading.[58]

Following World War II, the United States initiated dissolution of the large scale monopolies then existing in Japan, known as *zaibatsu*.[59] Long term solutions to thwart the possible re-emergence of monopolies were to be effected by the Antimonopoly Act.[60] This Act was based on two American models - the Sherman Act and Clayton Act - and prohibited the formation or existence of private monopolies and the unreasonable restraint of trade.[61] The Japanese did not adopt in practice the Antimonopoly Act since the Act's basic tenets were not customary in usually monopolistic Japanese markets, where the significant economic benefits to be gained from related company transactions and overall economies of scale were recognized. Several amendments to the Act through 1953 carved exceptions to the Act's stringent provisions and presented the opportunity for former *zaibatsu* members to reunite and become the current-day *keiretsu*.[62] The *keiretsu* obtained control over the companies within their "family" through one of two *keiretsu* structures - central bank *keiretsu* or distribution *keiretsu*.[63] The central bank *keiretsu* form around banks that benefit *keiretsu* members through the provision of easily attainable loans, reduced interest rates, and access to distribution systems. A trading company associated with the bank handles the distribution of group member products. This structure yields a horizontal grouping of large firms in various markets. The six largest central bank *keiretsu* control over half of the largest corporations in Japan, including its electronics and automotive industry.[64]

The other type of *keiretsu* is organized around a substantial company rather than a bank. The central company is the

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58. MICHAEL L. GERLACH, THE KEIRETSU: A PRIMER 8 (1992).
59. Hadley, *supra* note 55, at 367.
60. Act Concerning Prohibition of Private Monopoly and Maintenance of Fair Trade, No. 54 (1947) (*amended on* July 23, 1982).
61. Bader, *supra* note 54, at 369.
62. *Id.* at 370.
63. *Id.*.
64. *Id.* at 371.

primary purchaser of group member products. These *keiretsu* which are organized vertically can monopolize entire industries from manufacturing to retail.[65] The two types of *keiretsu* are not mutually exclusive and interlocking *keiretsu* of both types provide even greater opportunities for member benefits.[66] Although the Antimonopoly Act was again amended in 1977, its provisions have done little to disband the *keiretsu* structure.[67]

The *keiretsu* structure in Japan with either direct or indirect control across various group members provides a fertile ground for income and expense allocation abuse as addressed in I.R.C. § 482. In the event that a controlled entity is owned outright by a Japanese parent company, control is easily established. Unfortunately for the United States income tax administrators, that is usually not the case. The threshold question that must be answered affirmatively before § 482 reallocations can be made is whether a related entity is "controlled" either directly or indirectly by another. Partly as a result of the existing Japanese Antimonopoly Act (albeit often unenforced) and partly as a result of the Japanese culture itself, establishing control sufficient to effect reallocation under § 482 is a difficult task for U.S. tax authorities. Traditional discovery methods in litigation yield little evidence of probative value relative to establishing control under § 482.

Although non-tariff trade barriers to United States companies entering Japanese markets are the primary focus of *keiretsu* concerns,[68] the subtle, and at times not so subtle, erosion of the United States tax base is also a real concern. The underlying conflict between Japan and the United States in this area stems from basic cultural differences - the Japanese industrial policy which favors the monopolistic market and United States antimonopoly policy which promotes competitive

65. *Id.*.

66. *Id.*.

67. There are approximately six major groups of this type in Japan. Each tries to have a major company in each sector of the economy. The system thrives on cross-shareholding, thereby allowing managers to focus on long-term strategy instead of short-term financial performance.

68. Clyde V. Prestowitz, Jr., *How We Allowed Japan to Take the Lead*, TRADING PLACES, 48-61, 157 (1988).

markets.[69] Although the United States has challenged the *keiretsu* through the Structural Impediments Initiative and the Clinton administration's bilateral trade framework, little progress has been made to date.[70]

VII. SOLVING THE TRANSFER PRICING PROBLEM

The United States government has yet to discover "the" solution to the potential abuses inherent in transfer pricing. The issue is a two-edged sword. Overzealousness by U.S. tax authorities can create double tax burdens for U.S. taxpayers, stifle economic growth in the United States, and antagonize treaty partners. United States taxpayers, faced with the problem of double taxation are forced to resort to expensive and frustrating competent authority procedures. Conversely, ineffective enforcement of the reallocation provisions of § 482 reduces the amount of income taxes collected and exacerbates the United States' budget deficit problems.

The United States' solution to transfer pricing issues must, of necessity, be a global solution. The ultimate goal in solving these problems must be to allocate revenue geographically among competing tax jurisdictions.[71] Cultural differences between countries, such as the United States and Japan, are not going to disappear and these differences must be factored into any global solution fashioned. Bilateral attempts by the United States to address the problem only from its domestic perspective are ultimately doomed to failure in the global context.

The United States may reach agreement with a taxpayer as to the transfer pricing methodology to be used for particular goods, but a problem will still exist if the taxpayer's foreign tax jurisdiction does not agree with the pricing methodology of the United States. Such a situation would create double taxation

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69. Bader, *supra* note 54, at 376.

70. *United States-Japan Structural Impediments Initiative: Hearings Before the Senate Subcomm. on International Trade of the Comm. on Finance*, 101st Cong., 1st Sess., pt. 2, at 1-2 (1992).

71. Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?*, 56 TAX NOTES 339, 342 (1992) (contending that concentration on allocation methods ignores source issues).

burdens for the taxpayer and the necessity for competent authority intervention. Even with competent authority involvement there is no assurance that multilateral agreement will be reached retrospectively. The attempts, however, to reach agreements prospectively regarding transfer pricing issues should be expanded as part of this global solution.

The United States has attempted to address the transfer pricing problem over the last 35 years from the arm's length standard approach. This approach, although now the norm in the international community, has significant inherent problems in its administration. Documentation in foreign jurisdictions is difficult, if not impossible, to obtain. Many times there is no comparable sale to provide a basis for determining the arm's length transfer price. Section 482 of the Tax Reform Act of 1986 provides a manner to determine the income attributable to an intangible asset which is commensurate with the income from the asset. This "commensurate with income" standard was developed to establish transfer prices for intangible property.

Over the last several years an alternative long term solution to arm's length pricing methodology has gained support. The method is based on the adoption of a formulary approach to allocate the income geographically, and it is similar, in concept at least, to the commensurate with income standard, where affiliated corporations are treated as a single unit and the income of the unit is apportioned amongst tax jurisdictions based on a formula. The formula would consider such factors as assets, payroll, and sales in each jurisdiction in relation to the worldwide total of such factors within the unit.[72]

An optimal long-term solution to transfer pricing issues would rely on a restructuring of the overall approach, and the incorporation of those current policies and procedures which are working well, specifically:

- A formulary approach to the reallocation of income;[73]

72. Avi-Yonah, *supra* note 28, at 153.
73. *Id.*.

• International agreement on uniform rules of transfer pricing incorporating the formulary approach;

• Continuation of Advance Pricing Agreements to avoid disputes, but with the binding agreement of *all* related parties, precedential value of the agreements, and open forums; and

• Triangulation of the dispute resolution process[74] including competent authorities.

This long-term solution would not be simple to effect. Although the structures for advance pricing agreements are in place domestically and a United States conversion to a formulary approach could be accomplished in a reasonable period of time, the real challenge in a global solution is convincing the other taxing jurisdictions and sovereigns of the necessity for global cooperation. Openness in dispute resolution and pricing determinations is essential to an effective worldwide system.

Although the law itself in the Internal Revenue Code is rather straightforward, administration of that law has proven to be expensive and ineffective.[75] Transfer pricing cases are very burdensome, time-consuming, and expensive for all parties - the courts, I.R.S., and the companies involved[76] - and there is no guarantee of ultimate success.[77] The problem has not yet been solved. After 35 years of diligent efforts using the arm's length transfer pricing standard which have achieved only modest success in dealing with transfer pricing abuses, it is time to switch to a formulary approach in the United States. Global solutions to uniformity in transfer pricing issues, both retrospectively and prospectively, must be found.

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74. Clark, *supra* note 1, at 1209.

75. In 1992, the IRS proposed over $4 billion, in transfer pricing adjustments, and as of October, 1993, pending disputes of transfer pricing adjustments involved at least $11.3 billion in tax deficiencies. *See 1993 IRS Tax Enforcement Hearing before the Senate Comm. on Governmental Affairs*, 103rd Cong., 1st Sess. 5 (1993) (opening statement of Sen. Byron L. Dorgan).

76. Bureau of National Affairs, Tax Management Transfer Pricing Report, 135-36 (July 7, 1993) (In a recent transfer pricing case, Chevron produced 1.3 million pages of unlabelled documents for the I.R.S.).

77. Avi-Yonah, *supra* note 28, at 150.