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TRANSFER PRICING: ACHIEVING FAIR NATIONAL TAXATION OF INTERNATIONAL TRANSACTIONS*

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I: INTRODUCTION

Currently, taxation is based on the sovereignty of nations, whereby each nation taxes income derived from businesses within its sovereign control. International issues are addressed, to some extent, through a number of bilateral treaties, many based on an international model or convention,¹ mutual understandings, and practice. Taxation of international transactions by individual nations often results in confusion, disagreement, multiple taxation of the same income,² and, of

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1. See, e.g., Model Tax Convention on Income and on Capital, (OECD Sept. 1, 1995). The work and development of this have involved a number of countries, which refer to this model in the settlement of disagreements. The United States and Japan have both been very involved with the development and evolution of the Organization for Economic Cooperation and Development [hereinafter OECD] work on tax and transfer pricing.

2. For a discussion of the current situation as perceived by large multinational corporations, see Ernst & Young, *Transfer Pricing: Risk Reduction and Advance Pricing Agreements*, (Ernst & Young International Ltd. 1995) reprinted in 11 TAX NOTES INT'L 293 (July 31, 1995) [hereinafter Ernst & Young, *Transfer Pricing*].

course, taxable income which is not taxed by any nation. Concurrently, the fragmentation of taxation of international transactions into a number of national systems provides a significant opportunity to business entities for tax avoidance, evasion, or mistake.³

Transfer pricing, the price charged by one business entity to another for the provision of goods, services, or intangibles,⁴ constitutes the easiest way for reallocating income and expenses between entities.⁵ As part of their tax planning, many companies avail themselves of tax savings to be had by locating their services, production, or other facilities in regions with more favorable tax systems.⁶ Companies also structure themselves in order to minimize worldwide taxation.⁷ The line between tax planning and tax abuse is crossed when and if entities misuse transfer pricing.⁸ This occurs when the pricing of

3. See Charles F. Connolly, Comment, *The New Transfer Pricing and Penalty Regulations: Increased Compliance, Increased Burdens, and the Search for a Safe Harbor*, 16 U. PA. J. INT'L BUS. L. 339, 340 (1995).

4. TAX POLICY AND ADMINISTRATION ISSUES, GENERAL ACCOUNTING OFFICE, REPORT ON TRANSFER PRICING AND TAX COMPLIANCE OF FOREIGN AND U.S.-CONTROLLED CORPORATIONS 1 (Apr. 13, 1995), reprinted in Daily Tax Rep. (BNA) No. 92 at L-1 (May 12, 1995) [hereinafter TAX POLICY AND ADMINISTRATION ISSUES].

5. See Susan C. Borkowski, *Advance Pricing (Dis)Agreements: Differences in Tax Authority and Transnational Corporation Opinions*, 22 INT'L TAX J. 23 (1996).

6. For a discussion of this form of planning, "tax arbitrage," as an opportunity created by the nation-state taxing multinational businesses, see Walter F. O'Connor, *Editor's Note*, 22 INT'L TAX J. iii, iv (1996) (including examples such as hybrid company structures, cross-border leasing and licensing, and structuring products to gain different treatment in different states). For a brief review of an international meeting of tax lawyers discussing, contrasting, and developing models of transactions designed to benefit from international tax arbitrage, see *International Financial Transactions*, 12 TAX NOTES INT'L 1589 (May 20, 1996).

7. These structures are numerous and are often hybrid in order to fit under one country's definition of a particular structure while avoiding that of another or taking advantage of particular structurally-based tax advantages. An example of this is the commissionaire distribution structure wherein the local distribution subsidiary does not buy and resell goods, but sells goods in its own name on behalf of the foreign supplier as an undisclosed principal. The primary transfer pricing issue in this structure is the appropriateness of the commission paid the commissionaire, which is much simpler to compare and justify, leaving much more flexibility as to pricing strategies. See Martin R. McClintock & Stephen A. Ward, *International Tax and Business Planning Opportunities Through Commissionaire Arrangements*, 22 INT'L TAX J. 55 (1996) (describing the commissionaire structure, its objectives, advantages, and disadvantages).

8. The following is an example of potential tax problems arising from improper transfer pricing between two fictitious, related companies. NipponSoft Multi-national, headquartered in Osaka, Japan, develops and sells its patented and copy-

goods, services, intangibles, or other elements is artificially increased or decreased in order to shift income and/or expenses between entities for tax reasons.⁹ The difficulties inherent in the taxation of income shifted through transfer pricing are receiving increased attention at both the national and international levels,¹⁰ and constitute the most significant tax issue for multinational corporations today.¹¹

This article will examine the significance of transfer pricing. Further, it will review, as an example, the current national and international systems and procedures for identifying and capturing tax lost due to inaccurate transfer pricing used by two countries: the United States, as the originator and developer of much of the transfer pricing methodology, and Japan, one of the countries most actively involved in the regulation of transfer pricing and also a major trading partner of

righted software in Japan and worldwide. Transfer pricing to unrelated distributors provides NipponSoft with a gross profit of 67%. NipponSoft, U.S.A., a fully-owned subsidiary located in San Jose, California, sells and services its parent's software exclusively in the U.S.. Intercompany pricing is cost plus 20% profit. This subsidiary's net profits in 1996 exceeded the parent's company's unconsolidated earnings. Assume that the Japanese corporate tax rate is higher than the comparable U.S. rate.

9. See TAX POLICY AND ADMINISTRATION ISSUES, *supra* note 4. The definition of abusive transfer pricing practice used in United States tax treaties describes the practice as it would differ from pricing between unrelated parties:

Where a resident of a Contracting State and any other person are related and where such related persons make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, then any income, deductions, credits, or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income (or loss) of, or the tax payable by, one of such persons, may be allocated and utilized in computing the amount of the income subject to tax and the taxes payable by such resident of that Contracting State.

Convention between the United States of America and Japan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion Respect to Taxes on Income, Mar. 8, 1971, U.S.-Japan, art. 11, para. 1, U.S.T. 969, 1004 (1972) [hereinafter U.S.-Japan Tax Treaty].

10. See, e.g., Announcement 95-2, 1995-2, I.R.B. 59 (transfer pricing as main focus of IRS international examination activity and innovative methods for increasing voluntary compliance) [hereinafter Announcement 95-2].

11. See Ernst & Young LLP, *Ernst & Young 1995 Transfer Pricing Documentation Survey*, (Ernst & Young International Ltd. 1996), reprinted in 13 TAX NOTES INT'L 204 (July 15, 1996); see also Ernst & Young, *Transfer Pricing*, *supra* note 2.

the United States. It will include a brief analysis of current issues and possible solutions to transfer pricing.

II. THE SIGNIFICANCE OF THE TRANSFER PRICING ISSUE

Business, for better or for worse, comprises the most potent force for change in the world today. The impact of business is felt, not only economically, but also in the realms of science, education, politics, social mores, and culture, as well as within almost every other realm of our global society. Business has become the lifeblood and the changing force in the world and the patterns and dynamics of business drive development in all realms of daily life.

As the world economy is currently structured, potential tax consequences are a major factor in most business decisions, often the deciding factor. Tax policy also comprises a potent force in politics, economics, and environmental management, both within and between nations. Governments, politicians, business entities, lobbyists, and numerous others aspire to and succeed in shaping tax policy in order to support their particular goals. Nations use tax policy not only to raise revenues, but also to encourage and enforce national goals, ambitions, policies, and priorities. Many governments are creating incentives and placing pressures on firms and industries to internationalize.¹² For example, in order to develop self-sufficiency or a stronger economic base, many countries offer incentives to businesses to position parts of their manufacturing or services in specific countries and regions.¹³

Although taxation can serve in the achievement of political, developmental, and environmental goals, among others, the basic purpose of taxation is to generate revenue to contribute to the costs of maintaining the state. Traditionally, taxation has been based on a theory of territoriality, taxing income

12. See Peter F. Cowhey & Jonathan D. Aronson, *A New Trade Order*, 72 FOREIGN AFFAIRS 183 (1993).

13. See Jeffrey E. Garten, *Is America Abandoning Multilateral Trade?*, 74 FOREIGN AFFAIRS 50, 57-58 (1995) (discussing increasing U.S. and other nations' expanding government support for firms).

in the territory in which it is earned by the governing state's tax administration.

Increasingly, the geographic origin of income is not only difficult or impossible to determine, but also it is no longer necessarily a valid basis for taxation.¹⁴ Even in cases where it makes sense to levy tax based on the nation or territory where the income is earned, this demarcation becomes very difficult to ascertain when several locations are involved in the income generating process or product. Businesses are becoming increasingly integrated in order to achieve economies of scale, profit and product diversification, market penetration, complementary product production, and other business goals.¹⁵ This integration takes place vertically¹⁶ and horizontally as well as through formal and informal alliances inside and outside of specific industries and geographically, both domestically and internationally.¹⁷ Transnational corporations extend beyond national borders, are subject to the laws of more than one nation, and are increasingly recognized as international entities requiring not only international legal regulation, but also possible recognition as international legal persons.¹⁸

Technological advances enable some enterprises to conduct business multinationally without leaving the home office or

14. For a specific example, see Andrew M. Snyder, Note, *Taxation of Global Trading Operations: Use of Advance Pricing Agreements and Profit-Split Methodology*, 48 TAX LAW. 1057 (1995).

15. See, e.g., Cowhey & Aronson, *supra* note 11 (asserting that, despite government intervention, the world market is more thoroughly integrated than 20 years ago, and using the automobile industry as a specific example).

16. For an explanation of how - due to the nature of their transactions vertically integrated multinationals differ so greatly in their functions, contractual terms, risks, markets, and products for the uncontrolled transactions (that the Regulations require to be used as a basis to determine an arm's length price) - that it is unlikely that other transactions could be adjusted to be presented to the Service as sufficiently comparable transactions to justify the taxpayer's pricing, see Henry J. Birnkrant & James E. Croker, Jr., *Transfer Pricing Final Regs. Increase Flexibility, But Not Certainty in Choice of Method*, 81 J. TAX'N 268, 273 (1994).

17. For clear analysis and explanation of the semiconductor industry, computer industry, automobile industry, and telecommunications services as examples of this new economic order, see Cowhey & Aronson, *supra* note 11, at 185-191.

18. See MALCOLM N. SHAW, INTERNATIONAL LAW 171-172 (3d ed. 1995) (discussing the increased attention and practice in international law regarding the rights and duties of transnational corporations and the possibility that the latter could thereby be regarded as international persons).

sometimes even the home.¹⁹ The growth of technology, particularly communication, is making the world a smaller place at an incredibly quick pace. With the rapid development of the Internet, the location of a given sale or service becomes difficult, if not impossible, to place.²⁰ It is increasingly hard to determine where something is produced, designed, created, adjusted, or somehow had value added.²¹

As a greater proportion of taxable business income is derived from transactions which are international in nature, the significance and impact of the systems and procedures for this taxation evolve.²² The appropriate taxation of international business transactions, by its definition and nature, requires comprehension of the international systems within which the transactions occur. The direction applied to international business by taxation impacts the development, stability, and health of the world economy in profound and fundamental ways, due not only to fluctuations in tax revenues, but also to the myriad other effects of tax policy.

The tax authorities of a number of nations, including the United States, are increasing their review of transfer pricing practices,²³ particularly internationally within and between

19. For an industry-specific discussion of global trading operations and the difficulty of associating each business transaction with exact geographical locations for transfer pricing purposes, see Snyder, *supra* note 13. (Global trading operations are an excellent example of an industry which is not based on geographic location of the taxpayer or transaction and therefore is extremely vulnerable to double taxation, but not fitting well within the paradigms of transfer pricing regulations.)

20. O'Connor, *supra* note 6, at v.

21. See Jeffrey E. Garten, *American Trade Law in a Changing World Economy*, 29 INT'L LAW. 15, 22 (1995); see also O'Connor, *supra* note 6, at iv. For a description of the issues the Treasury Department is currently studying for its forthcoming paper on how to tax electronic commerce, acknowledging that it does not fit within the current parameters for transfer pricing regulation, such as permanent establishments, see *Treasury Paper Will Examine § 482 Issues Affecting Electronic Online Transactions*, Transfer Pricing (BNA) at 109 (July 3, 1996) (quoting Bruce Cohen, attorney adviser in U.S. Treasury's International Tax Counsel's office: "Could a computer server be a permanent establishment? Are there any circumstances under which a [World Wide Web] page that takes orders [could] be a permanent establishment?")

22. See Ernst & Young, *Transfer Pricing*, *supra* note 2, at 293-294 (describing the current systems and procedures as comprising a "global tax war" with the U.S. having made "the declaration of war"); cf. Garten, *supra* note 12 (discussing in this article the importance and definition of the right kind of multilateralism).

23. See, e.g., *Prepared Remarks by Commissioner of Internal Revenue Margaret*

multinational corporations. This heightened scrutiny is not surprising since it is estimated that nearly half of all trade among advanced nations takes place between related parties.²⁴ The amount of potential tax revenue involved in inaccurate transfer pricing is large²⁵ and increasing,²⁶ and leads to the likely conclusion that national tax authorities' efforts to pursue that revenue will also continue to increase.²⁷

Milner Richardson at Institute on Current Issues in International Tax, Dec. 14, 1995, 241 Daily Tax Rep. (BNA) at L-4, L-5 (Apr. 30, 1996). [hereinafter Prepared Remarks by Commissioner] (reaffirming the Service's commitment to transfer pricing and base erosion as the first of five areas in its international compliance plan and discussing progress); see also Study Shows Authorities Aggressively Questioning Practices of Multinationals, 137 Daily Tax Rep. (BNA) at G-2 (July 18, 1995) (citing a survey of 210 multinational corporations based in the U.S., U.K., Australia, France, Germany, Japan, and the Netherlands); Ernst & Young, Transfer Pricing, supra note 2, at 295 (stating that the activities most susceptible to transfer pricing disputes are: charges for administrative or managerial services, royalties for intangible rights, and transfers of finished goods for resale).

24. Ernst & Young, *Transfer Pricing*, supra note 2.

25. See *Study Says Pricing Abuse Cost \$33 Billion in Lost Revenue in 1993*, 2 TRANSFER PRICING (BNA) at 788 (1994) (study indicating that transfer pricing abuses cost the U.S. \$33 billion in tax revenue in 1993). Transfer pricing has been the basis for approximately 75% of I.R.S. adjustments to multinational corporations' income in recent years. See Marc M. Levey et al., *Transfer Pricing: Alternative Practical Strategies*, 890 T.M. § 7:I (1996) [hereinafter Levey et al., *Transfer Pricing*].

26. See, e.g., *Unagreed Transfer Pricing Adjustments Totaled \$911 Million FY 1995, IRS Says*, Daily Tax Rep. (BNA) No. 19 at G-2 (Jan. 30, 1996) ("IRS . . . reported that taxpayers agreed to \$727 million in transfer pricing adjustments during fiscal 1995, compared to \$566 million in fiscal 1994. This represents a 28 percent increase over the previous fiscal year. Total Section 482 adjustments in large cases totaled \$1.64 billion in fiscal 1995, compared to \$1.2 billion in fiscal 1994 - a 39% increase over fiscal 1994 . . .") [hereinafter *Unagreed Transfer Pricing Adjustments*].

27. See, e.g., *Prepared Remarks by Commissioner*, supra note 22, at L-5; see also *Survey of Multinational Companies Finds Majority Subject to Transfer Pricing Inquiries*, Transfer Pricing (BNA) at 163 (July 19, 1995) (quoting Michael Patton, chairman of Ernst & Young's International Transfer Pricing Task Force: "In the midst of the current global investment boom, national revenue authorities are scrutinizing transfer pricing practices more closely, introducing added uncertainties and risks into investment planning.").

III. CURRENT SYSTEMS AND PROCEDURES FOR HANDLING TRANSFER PRICING ISSUES

A. BACKGROUND

The body of tax law governing transfer pricing developed by the United States has influenced regulation of this type of pricing in other nations.²⁸ The concept of transfer pricing, as developed by the United States and currently the internationally predominant theory,²⁹ is that transfer pricing between entities should always reflect an "arm's length" price,³⁰ the price which unrelated and uninterested entities would charge each other; this arm's length price should be charged even if the entities are somehow related or otherwise share mutual interests. The purpose of arm's length pricing is to ensure that the profit margin falls within the geographical territory to which it is attributable and can be taxed by that state.

Although taxation still falls within the sovereign power of each nation, recognition of the need for international cooperation and compatible standards has led to the development of international models, definitions, and a vast network of bilateral treaties. Effective and non-duplicative taxation in a situation involving transfer pricing between entities subject to varied national taxing regimes requires those nations to interact and to understand each other's systems. This article includes a brief examination of how the United States and Japan have addressed transfer pricing within and between their tax administrations. These two countries serve as solid examples as they have developed transfer pricing regimes, are major trading partners, and have signed a bilateral tax treaty.³¹ Both Japan and the United States are actively developing their

28. See Sven-Olof Lodin, *Is the American Approach Fair? - Some Critical Views on the Transfer Pricing Issues*, 5 INTERTAX 240 (1995) (explaining the influence of U.S. regulations to § 482 prior to 1992 on OECD, its member countries, as well as other countries); see also Connolly, *supra* note 3, at 340.

29. See Leslie B. Samuels, *Remarks on Revenue Estimating and the OECD Transfer Pricing Guideline*, 2 INTERTAX 64, 68 (1995) (written version of speech given by Leslie B. Samuels, Assistant Secretary for Tax Policy, Treasury).

30. See Treas. Reg. § 1.482-1(b)(1) (1996).

31. U.S.-Japan Tax Treaty, *supra* note 8.

transfer pricing administrations and are extensively involved in the development of international guidelines.³²

B. UNITED STATES TRANSFER PRICING REGULATION

The United States regulates transfer pricing for both domestic and international transactions under the same overall law. Under Section 482 (hereinafter § 482) of the Internal Revenue Code, the Secretary of the Treasury is granted extensive power to make appropriate adjustments to an entity's reported income, expenses, credits, allowances, and so on, in reference to transactions of tangibles or intangibles, in order to prevent evasion of taxes or to more accurately reflect real income.³³ Administration of such a broad-sweeping section necessitates guidelines, standards, procedures, and systems. The major focus on implementation of § 482 began after the Tax Reform Act of 1986, wherein Congress focused on the inadequacy of the administration of this section, particularly in the transfer of intangibles.³⁴ Section 482 was modified to require

32. The United States and Japan have been involved in the development and implementation of the OECD transfer pricing work. Additionally, Japan and the United States are both members of the Pacific Association of Tax Administrators [hereinafter PATA], as are Australia and Canada. PATA members agreed upon expedited exchange of information guidelines in order to facilitate tax examinations and broad procedural guidelines in order to facilitate the competent authority portion of obtaining bilateral APAs. See Toshio Miyatake, *Transfer Pricing in Japan*, 2 THE TAX TREATMENT OF TRANSFER PRICING, Japan 1, Japan 51 (Int'l Bureau of Fisc. Doc. ed. 1995); see also *Sources Say At Least Two Japanese Banks Seeking Bilateral APAs with United States*, Transfer Pricing (BNA) at 204 (Aug. 2, 1995) [hereinafter *Japanese Banks Seeking Bilateral APAs*].

33. In this regard I.R.C. § 482 (1996) provides:

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 (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.

34. Bobbe Hirsh et al., *Final Transfer Pricing Regulations Restate Arm's*

that pricing for intangible property via a controlled transaction be commensurate with income produced by that property.³⁵ The Treasury Department produced a study in 1988, popularly known as the "White Paper," in response to Congressional concerns regarding the need for and possibilities of more thorough administration of transfer pricing.³⁶ The White Paper reinforced and accentuated the need for a more effective and efficient system to collect the tax revenue lost due to transfer pricing practices.³⁷

Since the White Paper, development of § 482 and the supporting regulations and procedures has been extensive and is still underway.³⁸ The U.S. regulations regarding transfer pricing abuse are considered to be the most aggressive.³⁹ Not only have the regulations relating to this section become increas-

Length Principle, 72 TAXES 587, 587-588 (Oct. 1994).

35. "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." I.R.C. § 482 (1996) (last sentence).

36. TREASURY DEP'T, A STUDY OF INTERCOMPANY PRICING UNDER SECTION 482 OF THE CODE (1988), reprinted in Notice 88-123, 1988-2 C.V. 458.

37. *See id.*

38. In 1994, the IRS released final § 482 regulations of general application, and those for determining the transfer prices for related party transfers of tangible property and intangible property. *See* T.D. 8552, 59 Fed. Reg. 34971 (1994). In 1995, transfer pricing regulations were issued for research and development cost sharing. *See* Treas. Reg. § 1.482-7 (1996). One foreign tax specialist has critically noted this burgeoning body of regulations:

The new regulations fill almost 150 pages and, including already existing rules concerning transfer pricing, the total number of pages of regulations aiming at developing the principles laid down in the few sentences of IRC Section 482 amounts to approximately 250 [a]lthough there are reasons to believe that this pile of rules and formulas will only to a very limited extent improve the possibilities to solve the transfer pricing issues in a fair and satisfactory way.

Lodin, *supra* note 27.

39. *See* Todd Wolosoff, *IRS Issues Final Transfer Pricing Penalty Regulations*, 12 TAX NOTES INT'L 706 (Mar. 4, 1996); *see also* Steven P. Hannes et al., *Handling Controversy and Planning Effectively Under the Final IRS Transfer Pricing Penalty Regulations*, 12 TAX NOTES INT'L 671, 672-673 (Feb. 26, 1996) ("the taxpayer bears the heavy burden of proving in a tax audit that its transfer pricing was 'correct,' and that an IRS-proposed pricing adjustment is 'wrong'") (citing *Altama Delta Corp. v. Comm'r*, 104 T.C. No. 22 (1995); *Seagate Tech., Inc. v. Comm'r*, 102 T.C. 149, 164 (1994); and *Perkin-Elmer Corp. v. Comm'r*, 66 T.C.M. (CCH) 634, 656-657 (1993).

ingly detailed, but they are also now reinforced by contemporaneous documentation and disclosure rules, as well as significant penalty provisions for substantial misstatement of transfer prices.⁴⁰

The officially stated 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.⁴¹ The existence of control is not a bright line, but is based on an examination of facts and circumstances, along with subjective assessment. The definition of “controlled” in the regulations is that it: “includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.”⁴²

Section 482 attempts to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, the “arm’s length standard,” which entails determining the true taxable income by what the results of the transaction would have been if undertaken by uncontrolled taxpayers under the same circumstances.⁴³ The determination of whether or not a transaction is controlled and which income is attributable to which part of a transactions is, unlike the simplicity of the goal, a gargantuan task and, often, if not always, virtually impossible to accomplish with precision.⁴⁴

40. Treas. Reg. § 1.6662 (1996); see also Marc M. Levey et al., *Final 482 Regs. Aim At More Flexibility But Retain IRS Audit Focus*, 5 J. INT’L TAX’N 456 (1994) [hereinafter Levey et al., *Final 482 Regs.*] (“armed with mountains of contemporaneous documentation required . . . taxpayers can be assured that the IRS will conduct audits of controlled-party transactions with unprecedented detail and zeal and that they truly will be required to meet their heavy burden of proof.”).

41. Treas. Reg. § 1.482-1(a)(1) (1996).

42. Treas. Reg. § 1.482-1A(a)(3) (emphasis added).

43. See Treas. Reg. § 1.482-1(b)(1).

44. The number of articles, books, and seminars produced, as well as the assortment of accounting firms, attorneys, and other specialists who make their living in this means is phenomenal. An entire article could be written cataloguing and comparing the sources of assistance in this regard. As an exhaustive list is beyond the scope of this article; several helpful articles are noted. See D. Kevin Dolan et al., *Final Transfer Pricing Regulations*, 23 TAX MGMT. INT’L J. 423 (1994); see also Laurent P. Guerard, *Selecting the Best Method: A Primer*, 4 Trans-

The current regulations require that the transfer pricing method selected confirm or determine what the transfer price would be in an arm's length transaction and must follow the "best method rule."⁴⁵ These provide the following methods for ascertaining the arm's length result in transactions based on the transfer of tangible property: comparable uncontrolled price, resale price, cost plus, comparable profit, profit split, and unspecified methods.⁴⁶ The best method is the one which provides the most reliable measure of an arm's length result given the specific set of circumstances and considering the completeness and accuracy of the data and the degree of comparability between the controlled and uncontrolled transactions.⁴⁷ More than one method may be appropriate and there may be several possible applications.⁴⁸

Although pricing decisions are made for a myriad of reasons other than immediate maximization of profit, the regulations governing the application of § 482 do not include many ways to justify a deviation from the arm's length standard.⁴⁹ For example, justifying pricing as a market strategy is limited to situations when the taxpayer is entering a new market and trying to establish a market share, and then only if the strate-

fer Pricing, Special Report No. 18 (BNA) at 1 (Oct. 18, 1995); Marc M. Levey & Cym H. Lowell, *Transfer Pricing Exam Strategy Evolves To A New Standard*, 6 J. INT'L TAX'N 504 (1995); Daniel S. Levy et al., *Economics and the New Transfer Pricing Regulations: Achieving Arm's Length Through the Invisible Hand*, 4 Transfer Pricing, Special Report No. 17 (BNA) at 1 (May 24, 1995); John P. Warner, *General Principles of Transfer Pricing Under the Final Revised Transfer Pricing Rules*, 36 TAX MGMT. MEMORANDUM 35 (1995); John P. Warner, *Transfer Pricing Under the Final Revised Transfer Pricing Rules*, 36 TAX MGMT. MEMORANDUM 51 (1995).

45. See Treas. Reg. § 1.482-1(c).

46. Treas. Reg. § 1.482-3(a) (1996). For a thorough description of these methods and their application, see Guerard, *supra* note 43, at 1. For the examples developed by the IRS, see examples given within the text of Treas. Reg. §§ 1.482-1-1.482-8.

47. See Treas. Reg. § 1.482-1(c)(2). However, the taxpayer must maintain documentation to establish that the method used provides the "most accurate" measure of an arm's length result. See Treas. Reg. § 1.6662-6(d)(2)(iii)(A), (C) (1996).

48. See Levey et al., *supra* note 39, at 457.

49. For a discussion of parent-survival premium as potential deviation from arm's length standard, with a specific analysis of *National Semiconductor Corp.*, see Marc M. Levey & Gregg A. Grauer, *Recognizing 'Parent-Survival Premium' in Transfer Pricing*, 5 J. INT'L TAX 541 (1994).

gy is comparable to that a similar company would pursue within the industry.⁵⁰

The best method rule, although flexible in appearance, requires significant time, expense, and risk to fulfill due to the need to review all methods to determine the best and the chance that the Internal Revenue Service (hereinafter I.R.S. or Service) may have a different opinion.⁵¹ In order to gain the most credibility and protection, the choice of method to be used for a transfer pricing study should be based on the comparability and the quality of the data and assumptions.⁵²

Although access to information may be difficult or limited, the taxpayer should strive to use the most comparable uncontrolled transactions available, as determined by the similarity of: functions of the parties, contractual terms, assignment of risks, economics, and property and services provided by either party.⁵³ The Service, taxpayers, and tax professionals have asserted that public information and voluntarily shared data are not sufficient for an investigation of transfer pricing cases.⁵⁴ Through its summons authority,⁵⁵ however, the Service has the power to acquire private business information to use for third party comparables.⁵⁶ The dilemma for the taxpayer

50. See Levey et al., *supra* note 39, at 458 (noting that, given a competitive world, the information required to document this may be impossible to obtain); see also Carlton M. Smith, *Documentation Needed to Avoid Penalties Specified by Transfer Pricing Temp. Regs.*, 80 J. TAX'N 304, 304-307 (1994) (note tone of article following subtitle stating, in part, "IRS is essentially asking for an indexed audit file.").

51. Levey et al., *Transfer Pricing*, *supra* note 24, at §7: I.E.

52. Cf. Treas. Reg. § 1.6662(d)(2)(ii) (1996); see Levey et al., *supra* note 39, at 457; see also Hannes et al., *supra* note 38, at 672-673 (explaining why a taxpayer should at least document why it is reasonable to conclude that no further consideration of other methods is necessary).

53. Treas. Reg. § 1.482-1(d)(3) (1994). See Levey et al., *Final 482 Regs.*, *supra* note 39, at 457.

54. See Ryan J. Donmoyer et al., *IRS To Pursue More Third-Party Comparables in Transfer Pricing Cases*, 10 TAX NOTES INT'L 894 (Mar. 13, 1995). For a discussion of the results of an IRS survey showing the inadequacy of the third party comparable information available to the Service from public sources and voluntarily shared information, see *IRS Survey Results Reveal Inadequacy of Third Party Information Data Sources*, Daily Tax Rep. (BNA) No. 42, at G-1 (Mar. 3, 1995).

55. I.R.C. § 7602 (1996).

56. See Donmoyer et al., *supra* note 53, at 894 (quoting Margaret Richardson,

is how to determine and acquire the highest quality data possible,⁵⁷ given that the most comparable information would probably be that of the taxpayer's most direct competitors.⁵⁸ Once a taxpayer has determined the information available on comparables and the industry as a whole, the choice remains as to which method most reliably reflects an arm's length price given the specific circumstances of the transaction studied.

Transfer pricing studies can be done in-house or by an outsider.⁵⁹ Whether or not to actually devote the resources for documentation, either internally or externally, is a management decision, which may be based on potential penalty exposure.⁶⁰ In deciding whether or not to document, a taxpayer should consider that extensive contemporaneous documentation created by the time of filing the return may provide the taxpayer with protection from transfer pricing penalties.⁶¹ Any documentation prepared must be carefully and thoroughly analyzed and supportive of the taxpayer's position as the IRS

IRS Commissioner, affirming the Service's right to obtain third party comparable information, explaining past practice as exercising "restraint," and noting that this will change if necessary to get "the information we need to effectively administer the transfer pricing regime.").

57. For a thorough discussion of the importance of quality data, how to identify it, assess it, substantiate it, and make appropriate adjustments, see Marc M. Levey et al., *Defining 'Quality' Data in a Transfer Pricing Analysis*, 7 J. INT'L TAX 4 (1996).

58. See Levey et al., *Final 482 Regs.*, *supra* note 39, at 457.

59. See *Taxpayers Should Not Rush into Studies for §6662 Purposes*, *Tax Executive Says*, Transfer Pricing (BNA) at 111 (July 3, 1996) [hereinafter *Taxpayers Should Not Rush into Studies for §6662 Purposes*].

60. See *id.* at 111 (quoting Alan O. Dixler, Merck & Co.'s senior tax counsel).

61. See Treas. Reg. § 1.6662-6(d)(2)(iii) (1996). This documentation must include the following:

1. Overview of the taxpayer's business, including analysis of economic and legal factors affecting the pricing;
2. Description of organization and of all related parties engaged in, directly or indirectly, affecting pricing;
3. Documentation explicitly required by § 482 regulations;
4. Description of method and why selected;
5. Description of methods considered and why not selected;
6. Description of controlled transactions and internal data used to analyze them;
7. Description of comparables used, determination of what is "comparable" and adjustments made; and,
8. Explanation of economic analysis and projections relied upon in developing the method.

See Wolosoff, *supra* note 38, at 708.

or a foreign tax authority can use the documentation provided to construe and support an adjustment or penalty.⁶²

Although transfer pricing issues are complex for tangible products, transfer pricing issues in the areas of services and intangibles are even more difficult to analyze. Transfer pricing regulations for intangibles are a current priority for the Service as intangibles constitute a substantial and ever-increasing factor in U.S. exports in recent years.⁶³ The current methods available for determining an arm's length price are difficult to apply to intangibles. For example, in the situation where reliable internal comparable intangibles exist, the comparable uncontrolled transaction method can be used (and some insist it must be used) to determine transfer prices for intangible property.⁶⁴ The other two specified methods for intangibles are the comparable profits method and profit split method.⁶⁵ The proposed regulations for services were originally scheduled to be completed during 1996, but the project was dropped mid-year for unspecified reasons.⁶⁶

One uncertain area in regard to transfer pricing for intangibles has been the determination of ownership of an intangible, and, therefore, the appropriate allocations of and adjustments to income, expenses, and profit. Prior to 1994, the "developer," the party that created the intangible's economic value, was entitled to profit from the intangible.⁶⁷ The regulations now provide that determination of ownership of an intan-

62. See Hannes et al., *supra* note 38, at 679-680 (discussing further on pp. 681-683 the advisability of initial information preparation under the attorney-client privilege in order to determine direction and strategy).

63. Intellectual property exports were estimated at 12% in 1983 and 25% of total U.S. exports in 1991. Jeffrey E. Garten, *American Trade Law in a Changing World Economy*, 29 INT'L LAW. 15, 22 (1995) (citing Ralph Oman, Register of Copyright). U.S. financial services exports in 1994 were more than \$8 billion. See Garten, *supra* note 12, at 57.

64. For a detailed analysis and examples of why and how the CUT method must be used in this situation, see Richard P. Rozek, *Applying the Best Method Rule When Reliable Internal Comparable Intangibles Exist*, 12 TAX NOTES INT'L 1191 (Apr. 18, 1996).

65. Treas. Reg. § 1.482-4(a) (1996).

66. *IRS Drops Project to Propose Rules for Pricing Related-Party Services in 1996*, Daily Tax Rep. (BNA) No. 107, at G-3 (June 4, 1996).

67. See, Richard Boykin, *Transfer Pricing Policy Issues: Who Is the Developer?*, 12 TAX NOTES INT'L 279 (Jan. 22, 1996).

gible begins with the legal owners of the right to exploit the intangible.⁶⁸ In order to clarify pricing and expenses, the regulations now allow for the allocation of profits derived from an intangible to be specified by the parties through the creation of an appropriate research and development cost sharing arrangement.⁶⁹

C. TRANSFER PRICING ENFORCEMENT AND ISSUE RESOLUTION IN THE UNITED STATES

1. Adjustments

Transfer pricing is a priority area of enforcement for the IRS and the Treasury.⁷⁰ The adjustments emanating from application of § 482 represent a growing potential source of tax revenue. Although a lesser amount will eventually be realized as revenue, the IRS had \$911 million in unagreed adjustments from large case examinations at the end of fiscal 1995; this represented an increase of fifty percent over the \$615 million for fiscal 1994.⁷¹

2. Penalty Regulations

The United States' transfer pricing penalties constitute the most severe of all countries.⁷² Transfer pricing penalties are made at two levels: the specific transactional level and the net section 482 adjustment penalty for affiliated groups filing a consolidated return.⁷³ The penalty thresholds are low enough

68. Treas. Reg. § 1.482-4(f) (1996).

69. In December 1995, the IRS finalized regulations dealing with research and development cost-sharing. See Treas. Reg. § 1.482-7 (1996). For a description and analysis of the extensive documentation and comprehensive contract required under the provisions of this regulation, see Hannes et al., *supra* note 38, at 677-678.

70. Transfer pricing is the center focus of a program entitled "Tax Compliance in a Global Economy" jointly announced by the Treasury Department and the Internal Revenue Service in 1994. See Samuels, *supra* note 28, at 65.

71. See *Unagreed Transfer Pricing Adjustments*, *supra* note 25, at G-2.

72. See Wolosoff, *supra* note 38, at 706.

73. Under I.R.C. § 6662(e),(h) (1996) penalties include:

- Transaction penalty for a valuation misstatement:
- 20% penalty for pricing which is either 200% or more than correct price or 50% or less;
 - 40% penalty for pricing which is 400% or more than correct price or 25% or less;

to be crossed easily by a taxpayer with a large volume of transnational transactions.⁷⁴ The penalties constitute a sufficient financial burden that, for many taxpayers, avoiding them is as important, if not more important, than avoiding double taxation.⁷⁵ Also, the penalty statute has already had the unintended, but appropriate, effect of causing some tax directors to embrace transfer pricing as a U.S. and foreign tax planning opportunity, not just a problem.⁷⁶

The Service may exclude a transfer pricing adjustment from penalty provisions if the pricing analysis is documented as set forth in the regulations and if either the specified or unspecified method requirement for establishing an arm's length price is met.⁷⁷ If the documentation process is to serve as an effective prophylactic against penalties, it should not only be thorough, but also begun early.⁷⁸ In order to serve as an exception to penalties, the documentation requirements for the specified method must: be met by documents created by the time of filing for the given year, be furnished to the IRS within thirty days of an IRS request, and include documentation setting forth the taxpayer's business, relationships, structure, and a thorough pricing analysis.⁷⁹ The extent and thor-

- 40% penalty for the failure to charge for transfer of any tangible or intangible property.

Net § 482 Adjustment Penalty:

- 20% penalty if net adjustment exceeds either \$5 million or 10% of gross receipts;

- 40% penalty if net adjustment exceeds either \$20 million or 20% of gross receipts.

For an overview see Wolosoff, *supra* note 38, at 709.

74. Note that an IRS adjustment of 1% on an amount over \$5 million would subject the entity to the 20% net adjustment penalty. See Birnkrant & Croker, Jr., *supra* note 15, at 268; see also Hannes et al., *supra* note 38, at 672-673. The final regulations do allow that if a proposed adjustment is small in relation to the dollar amount of the controlled transaction to which it relates, this fact is relevant in determining if a taxpayer made a reasonable effort to apply a specified or unspecified method. See Treas. Reg. § 1.6662-6(d)(2)(ii)(G) (1996).

75. See Birnkrant & Croker, Jr., *supra* note 15, at 268.

76. See Hannes et al., *supra* note 38, at 672.

77. See Treas. Reg. § 1.6662-6(d) (1996); see footnote 60, *supra*, for list of documentation required.

78. Cf. Hannes et al., *supra* note 38, at 671 (discussing specifically how tax planning and documentation should be conducted to avoid penalty and adjustment exposure).

79. See Wolosoff, *supra* note 38, at 708. The list of documents required is

oughness of data research required in order to be safe are considered to be a facts and circumstances test, but remain nebulous.⁸⁰ The Appeals Division of the IRS is faced with a heavy burden in cases subject to transfer pricing penalties due to the extensive documentation which must be analyzed in the re-calculation of the penalties and the assessment as to whether the documentation suffices to meet the regulations.⁸¹

3. Advance Pricing Agreements

In order to alleviate the uncertainty, cost, and time spent resolving transfer pricing disputes, the United States created the advance pricing agreement process (hereinafter APA).⁸² This is one of several methods of alternative dispute resolution initiated by the Service in order to increase voluntary compliance by taxpayers.⁸³ APAs are agreements that for a fixed term, the authority will accept an agreed transfer pricing method used by a group. Such agreements are formal in nature with fixed terms and limits; they are obtained through a process of formal inquiry and negotiation and based on statute.⁸⁴ The APA is the only way for the taxpayer to achieve pricing certainty and penalty avoidance.

The costs of establishing an APA are large enough for both the taxpayer and the participating tax bodies so that the costs and benefits require careful consideration. An APA involves three types of costs: internal time, consultants' fees, and governmental fees.⁸⁵ The taxpayer bears a very substantial cost

given in Treas. Reg. § 1.6662-6(d)(2)(iii)(B) (1996).

80. See Treas. Reg. § 1.6662-6(d)(2)(ii)(B) (1996) ("the expense of additional efforts to locate new data may be weighed against the likelihood of finding additional data that would improve the reliability of the results and the amount by which any new data would change the taxpayer's taxable income."); see also *IRS Final Regulations*, 12 TAX NOTES INT'L 563, 564 (Feb. 19, 1996).

81. See *IRS Appeals Division Studying How To Handle Transfer Pricing Penalties*, Dougherty Says, Daily Tax Rep. (BNA) No. 195, at G-2 (Oct. 10, 1995). [hereinafter *IRS Appeals Division Studying How To Handle Transfer Pricing Penalties*].

82. See Seymour Zwick & Theresa Dilworth, *Alternative Dispute Resolution or Examination by IRS*, Transfer Pricing (BNA) at 455 (Dec. 13, 1995).

83. See *id.*

84. This reflects an international definition of APAs, used by Ernst & Young for an international transfer pricing study. Ernst & Young, *Transfer Pricing*, *supra* note 2, at 295.

85. See *id.* at 310.

in terms of time and money in putting together the information required for an APA and negotiating it with the taxing authorities involved.⁸⁶ However, the analysis, planning, and documentation required to prepare an APA build on the work necessary to protect oneself from the penalty regulations in the event of a transfer pricing controversy.⁸⁷ Previously completed APAs are not published or disclosed⁸⁸ and do not serve as precedent.⁸⁹ In the United States, the sheer volume of information involved and the unique nature of each case create an enormous work load for the IRS.⁹⁰

The APA process is lauded by a number of the participants as a solution to transfer pricing issues. Despite the cost, time, and effort involved, a number of tax practitioners still believe the APA process to be the most effective alternative dispute resolution method for taxpayers to resolve transfer pricing issues.⁹¹ A number of multinational corporations also believe that the APA process is of major benefit as it affords companies a greater level of certainty as to the tax implications of their covered activities.⁹² The number of APAs is actually growing,⁹³ although it is not certain that it will be possible for

86. *See id.*

87. *See* Hannes et al., *supra* note 38, at 680.

88. *See, e.g., IRS Asks Court to Dismiss BNA Lawsuit Seeking Disclosure of APA Methodologies*, Daily Tax Rep. (BNA) No. 83, at G-4 (Apr. 30, 1996).

89. However, a taxpayer may rely on a transfer pricing methodology developed and applied in its own APA in post-APA years as "reasonable" in order to avoid penalties. *See* Treas. Reg. § 1.6662-6(d)(2)(ii)(F) (1996).

90. *See, e.g., Manhattan District Office Designates Two Officials To Handle APA Requests*, Transfer Pricing (BNA) at 99 (June 21, 1995) (for the first time at the district level, IRS designates two officials at Manhattan office to handle heavy APA load).

91. *See, e.g., Zwick & Dilvorth, supra* note 81, at 459; *see also Taxpayers Should Not Rush into Studies for §6662 Purposes, supra* note 58, at 111 (quoting Alan O. Dixler, Merck & Co.'s senior tax counsel: "If you can mobilize the resources, then do an APA. It takes the transfer pricing issue off the table.").

92. *See* Snyder, *supra* note 13, at 1068-1069; *see also Study Shows Authorities Aggressively Questioning Practices of Multinationals*, 137 Daily Tax Rep. (BNA) G-2 (July 18, 1995) (citing a 64% of a survey of 210 multinational corporations based in the U.S., U.K., Australia, France, Germany, Japan, and the Netherlands, as stating that they would "likely" or "very likely" use APAs).

93. For example, government studies covering years *past* have indicated that the number of completed APAs in March, 1993, was 9, and as of January, 1995, was approximately 26. *See supra* TAX POLICY AND ADMINISTRATION ISSUES, note 4, at 7.

it to grow to sufficient capacity for the rapidly increasing number of transactions with potential transfer pricing issues.

4. Mediation

In order to expedite transfer pricing cases, the Service decided to try mediation as a methodology for resolving transfer pricing issues between the taxpayer and the Service.⁹⁴ The mediator is jointly selected by the parties, either from another Appeals office or from outside of the Service,⁹⁵ and some taxpayers are requesting and being allowed to have two mediators handle a case, one from Appeals and one from outside the IRS; each mediator hears the case separately.⁹⁶

5. Hybrid: Concurrent Advance Pricing Agreement and Joint Consideration of Pending Disputes

One successful program involves joint resolution of transfer pricing issues by Appeals and the U.S. Competent Authority.⁹⁷ The Service is considering an alternative dispute resolution program which would allow a taxpayer to resolve potential transfer pricing disputes and pending disputes on the Examination, Appeals, and docketed levels by requesting an APA and, under the Simultaneous Appeals Process (SAP), joint consideration of pending disputes.⁹⁸

94. See Announcement 95-2, *supra* note 9 (announcing a one year trial period beginning October 30, 1995). As of June, 1996, three cases had been resolved through this program; none involved § 482; see *IRS Devising Way to Settle Docketed Cases Based on APAs, Appeals Settlement Terms*, Transfer Pricing (BNA) at 109-110 (July 3, 1996) (reporting an address made by Thomas Louthan, director of Appeals' Office of Dispute Resolution & Specialty Programs at a World Trade Institute seminar) [hereinafter *IRS Devising Way to Settle Docketed Cases*].

95. See *supra* Announcement 95-2, note 9 (announcing a one year trial period beginning October 30, 1995).

96. See *IRS Devising Way to Settle Docketed Cases*, *supra* note 93, at 110.

97. See *IRS Appeals Division Studying How To Handle Transfer Pricing Penalties*, *supra* note 80, at G-2.

98. See *IRS Devising Way to Settle Docketed Cases*, *supra* note 93, at 110.

D. JAPANESE TRANSFER PRICING REGULATION

Japan's international transfer pricing rules are distinct from its domestic rules to prevent tax avoidance via arbitrary pricing.⁹⁹ Japanese international transfer pricing rules were enacted and codified as Article 66-5 (later 66-4) of the Special Taxation Measures Law (STML) on 28 March 1986, based on a report by the Tax Commission in December of the previous year on the extent of transfer pricing and the need for new tax provisions.¹⁰⁰ Although the drafters of the Japanese transfer pricing rules studied the rules of a number of countries, including the United States, they chose to use the Model developed by the Organization for Economic Cooperation and Development (hereinafter OECD Model)¹⁰¹ as a basis for Japan's transfer pricing legislation.¹⁰²

In order to make an adjustment for transfer pricing, the government must prove both that the transaction was conducted between a corporation subject to Japanese corporate tax and its foreign related person, and that the price charged was not an arm's length price.¹⁰³ In the event that a corporation's transaction price in a transaction with a foreign related person¹⁰⁴ is not an arm's length price,¹⁰⁵ it may be adjusted to an arm's length price for the purpose of the computation of corporation tax.¹⁰⁶ A sufficient relationship exists to investi-

99. The three traditional approaches under Japanese corporate tax law for dealing with tax avoidance based on arbitrary pricing are: (1) by reference to the definition of revenue, (2) through the use of the provisions governing donations, and (3) the denial of acts or accounting of a family company. See Miyatake, *supra* note 31, at Japan 13-16 (describing the use and effect of these three approaches).

100. See *id.* at Japan 16-17.

101. Model Double Taxation Convention on Income and Capital, 1977, Organization for Economic Cooperation and Development [hereinafter Model Double Taxation Convention]. The OECD Model was revised in 1992 and again in 1995. Model Tax Convention on Income and Capital, Sept. 1, 1992, Organization for Economic Cooperation and Development, Tax Treaties (CCH) ¶ 191, Tax Treaties (WGL) ¶ 2001 [hereinafter Model Tax Convention on Income].

102. See Miyatake, *supra* note 31, at Japan 17.

103. The government has the burden of proof in transfer pricing taxation cases. See *id.* at Japan 60.

104. Japan's international transfer pricing provisions apply only to transactions conducted by an entity required to pay corporation tax in Japan with a foreign related corporation. See *id.* at Japan 23.

105. See *Business in Japan*, 51 7th TAX MGMT. PORT. (BNA) II.B.6.b.(2) (1996) [hereinafter *Business in Japan*].

106. See Miyatake, *supra* note 31, at Japan 17 (including those in force as of

gate transfer pricing issues when one of two special relationships exist: either corporation directly or indirectly owns 50% or more of the total issued shares of the other, or controls said corporation "in substance."¹⁰⁷ Control in substance means that one corporation can basically determine all or a portion of the business policies of the other corporation due to relationship(s) between the officers, employees, or corporations as a whole.¹⁰⁸

Japan has specifically adopted the concept and definition of arm's length price as stated in the 1979 OECD Report on Transfer Pricing, as well as emulates its methods for computing an arm's length price.¹⁰⁹ In Japan, an arm's length transaction price for the sale of tangible property is computed under one of three methods: comparable price, normal reseller's profit, or cost plus normal supplier's profit.¹¹⁰ The Japanese Ministry of Finance also plans to add an additional transfer pricing method approved by the OECD, the transactional net margin method (TNMM); under this method, profits are calculated in light of typical profit margins of comparable, unaffiliated taxpayers.¹¹¹ The tax office also has the flexibility to consider costs and expenses of business, fixed assets used in the business, and other factors if one of the three primary methods cannot be used to determine an arm's length transaction price.¹¹²

The determination of an arm's length transaction price for transactions other than the sale of inventory is authorized

July 1994) (explaining the provisions of Art. 66-4, para. 1 of the Special Tax Measures Law).

107. See Boidman et al., *Transfer Pricing Rules and Practice in Japan*, TRANSFER PRICING: FOREIGN RULES AND PRACTICE OUTSIDE OF EUROPE, TAX MGMT. PORT. (BNA) ch. 33, II.A.3.c (1996); see also Miyatake, *supra* note 31, at Japan 18-21 (including diagrams of how to determine 50% ownership in a chain of ownership).

108. See Boidman et al., *supra* note 106, at ch. 33, II.A.3.c.2. (citing and explaining Special Taxation Measures Law Enforcement Order No. 43 of 1957 as amended, article 39-12).

109. See Miyatake, *supra* note 31, at Japan 21.

110. See *Business in Japan*, *supra* note 104, at II.B.6.b.(2).

111. *Pre-Confirmation System To Be Made Law To Expedite Agreements*, MoF Officials Say, Transfer Pricing (BNA) at 94 (June 16, 1996) [hereinafter *Pre-Confirmation System To Be Made Law*].

112. *Business in Japan*, *supra* note 104, at II.B.6.b.(2).

using methods "similar" to those used for tangible goods.¹¹³ Additionally, a safe harbor exists for rental of Japanese real estate to foreign affiliates, due to the high value of real estate in Japan.¹¹⁴

E. TRANSFER PRICING ENFORCEMENT AND ISSUE RESOLUTION IN JAPAN

1. Adjustments

The Commissioner of the National Tax Administration (hereinafter NTA) has the ultimate authority to make transfer pricing adjustments, but the actual adjustments are made by examiners.¹¹⁵ During its 1994 tax year, ending June, 1994, the NTA issued 60 deficiency assessments, totaling 120 billion yen, approximately \$1.5 billion U.S..¹¹⁶

2. Advance Pricing Agreements

The National Tax Administration initiated its Pre-Confirmation System (hereinafter PCS) program, for unilateral advance agreements, in 1987.¹¹⁷ The application for a PCS requests disclosure and a thorough analysis of the transactions, relationships, and justification of the selected transfer pricing method.¹¹⁸ Each PCS requires an economic study and may

113. *See id.*

114. An annual rental of 8% of the value of the real estate as appraised for inheritance tax is acceptable. This appraisal is normally considered to be much less than the fair market value. In order to avail itself of this safe harbor, the rental must be confirmed with the tax office and is subject to revision when the appraisal is reviewed, usually every 3 years. *See id.*

115. *See Miyatake, supra* note 31, at Japan 50.

116. *NTA To Shift AFA Functions To Regional Bureaus, Sources Say*, Transfer Pricing (BNA) at 77 (June 7, 1995) [hereinafter *NTA To Shift AFA Functions To Regional Bureaus*].

117. *Japan*, Transfer Pricing (BNA) at 12 (Apr. 12, 1995) [hereinafter *Japan*, Transfer Pricing].

118. Information is requested about:

- The taxpayer's foreign affiliate;
- The volume and value of related-party transactions;
- Terms and conditions of the transactions;
- Functions performed by the taxpayer;
- Market conditions; and
- An explanation of why the selected transfer pricing methodology is the

most reasonable.

take two to three years to negotiate,¹¹⁹ although the NTA is trying to expedite the negotiation process.¹²⁰ Apple Computer Japan Inc. and J.P. Morgan Inc.'s Japanese affiliate were the first two foreign taxpayers to use Japan's Pre-Confirmation System to receive prospective approval of transfer prices.¹²¹

The NTA is steadily increasing the size and importance¹²² of its transfer pricing function in response to the need to develop transfer pricing policy, as well as the ever-increasing numbers of transfer pricing cases¹²³ and requests for advance pricing agreements.¹²⁴ Out of ten Japanese multinational corporations which participated in an international study of transfer pricing, seven view transfer pricing as the most important international tax issue facing them; and, all but one, expect the use of APAs to grow.¹²⁵ Six of the Japanese multinational corporations in the aforementioned study

See *Japan, Transfer Pricing*, *supra* note 116, at 12. The analysis given must include comparables and adjustments made for the study. *Id.*

119. See *id.*; see also *Pre-Confirmation System To Be Made Law*, *supra* note 110, at 94 (practitioners estimating an average PCS agreement requires three years of negotiation).

120. See, e.g., *NTA To Shift AFA Functions To Regional Bureaus*, *supra* note 115, at 77; see also *J.P. Morgan Concludes Bilateral APA with IRS, NTA, Sources Say*, *Transfer Pricing (BNA)* at 367 (Nov. 1, 1995) (indicating that J.P. Morgan bilateral APA was approved by Japan's National Tax Administration approximately one year after filing request) [hereinafter *J.P. Morgan Concludes Bilateral APA*].

121. See *J.P. Morgan Concludes Bilateral APA*, *supra* note 119, at 367.

122. The Japanese government plans to write a law as basis for the Pre-Confirmation System, rather than the current NTA notice, in order to gain it more respect, thereby increasing usage of it and expediting processing of PCS agreements. See *Pre-Confirmation System To Be Made Law*, *supra* note 110, at 94.

123. See *NTA To Shift APA Functions To Regional Bureaus*, *supra* note 115, at 77 (reporting that NTA issued 60 deficiency assessments in 1994 tax year and anticipated 80 for its 1995 tax year).

124. See, e.g., *NTA Says 25 Examiner Jobs To Be Created; New Divisions in Kanto Plains, Tokyo Planned*, *Transfer Pricing (BNA)* at 70 (June 5, 1996); see also *NTA to Increase Transfer Pricing Staff by 17 in Regional Bureaus, Officials Say*, *Daily Tax Rep. (BNA)* No. 99, at G-2 (May 22, 1996) (indicating also a status upgrade of office handling, competent authority issues to a division, and creation of new levels of hierarchy within existing transfer pricing administrative structure); *NTA To Shift AFA Functions To Regional Bureaus*, *supra* note 115, at 77 (stating that shift is due to substantial increase in number of APA applications and will include corresponding increase in transfer pricing personnel); *Pre-Confirmation System To Be Made Law*, *supra* note 110, at 94 (estimating 20 applications for PCS agreements pending from Japanese and foreign taxpayers as of June, 1996).

125. Ernst & Young, *Transfer Pricing*, *supra* note 2, at 297.

have faced transfer pricing inquiries in countries in which they have subsidiaries; four of them also faced such inquiries in Japan.¹²⁶

IV. INTERNATIONAL INVOLVEMENT IN TRANSFER PRICING ADMINISTRATION

The internationalization of legal regulation of multinational businesses is accelerating as countries attempt to keep pace with the globalization of the world business community.¹²⁷ Although taxation is considered a sovereign domain of the nation-state, there is actual and potential conflict and overlap between international law and the tax laws of individual nations. The bilateral tax treaties and national tax laws may not accord with each other, or with the provisions and detail of the increasing number of treaties and other international law governing international trade and business, including: GATT, WTO, EEC, NAFTA, ASEAN, APEC, OECD, and others.

Resolution of overlaps and conflicts in the area of taxation in general and transfer pricing in particular is currently being addressed through a series of bilateral tax treaties as well as the work of international organizations to develop conventions, models, guidelines, and practices. This body of international work and cooperation is necessary not only to address areas of overlap or conflict between tax regimes, but also because the effective and efficient enforcement of taxation of multinational businesses requires multinational enforcement and cooperation.¹²⁸

A. BILATERAL TAX TREATIES

Many nations have adopted bilateral tax treaties to prevent tax evasion and double taxation.¹²⁹ International model tax treaties have been developed by the United Nations and the Organization of Economic Cooperation and Development

126. *Id.*

127. See Lance C. Tyson, *Unitary Apportioning: A Key to Global Tax Harmony*, 22 INT'L TAX'N J. 35 (1996).

128. See O'Connor, *supra*, note 6, at iv.

129. See, Ernst & Young, *Transfer Pricing*, *supra* note 2, at 294.

(hereinafter OECD).¹³⁰ Japan and the United States are parties to a bilateral tax treaty (hereinafter U.S.-Japan Tax Treaty).¹³¹ Japan has concluded at least 45 income tax treaties,¹³² while the United States is a party to more than fifty-seven bilateral income tax treaties.¹³³

The U.S.-Japan Tax Treaty, like the vast majority of tax treaties, contains a "competent authority" or "mutual agreement" provision, authorizing the competent authority of each country to meet to resolve issues of misapplication or double taxation under the pertinent treaty.¹³⁴ The competent authority for Japan is comprised of the Deputy Commissioner, International, and the Director, Office of International Operations;¹³⁵ for the United States it is the Secretary of the Treasury.¹³⁶ The competent authority provisions also generally grant a resident¹³⁷ of a contracting state the right to request the competent authority of that state to initiate proceedings in the case of double taxation or taxation which the taxpayer believes to conflict with the treaty.¹³⁸

The issue of transfer pricing as it is defined involves a tension between the taxing authorities/interest of nations and the business(es) involved, which is particularly evident in the competent authority process, both in the United States and in Japan. The right to request competent authority assistance is not the right to receive such assistance.¹³⁹ The use of compe-

130. See Model Double Taxation Convention, *supra* note 100.

131. See US-Japan Tax Treaty, *supra* note 8.

132. See Miyatake, *supra* note 31, at Japan 11-12 (including those in force as of July, 1994).

133. As of April, 1995, the United States had entered into 57 income tax treaties. All but two of these (with Bermuda and Ireland) contain a provision whereby the competent authority of each country can meet to resolve issues of double taxation or inappropriate application of the terms of the treaty. See John Venuti et al., *Requesting Competent Authority Assistance: IRS Proposes New Procedure*, 24 TAX MGMT. INT'L J. 229 (1995).

134. See Ernst & Young, *Transfer Pricing*, *supra* note 2, at 294.

135. See Boidman et al., *supra* note 106, at ch. 33.

136. It is delegated to the Assistant Commissioner (International) of the Internal Revenue Service. Delegation Order No. 114 (Rev. 9) § 1, 1990-2 C.B. 326. For a thorough discussion of competent authority and usage, see Paul C. Rooney & Nelson Suit, *Competent Authority*, 49 TAX LAW. 675 (1996).

137. A resident in this sense includes either a natural person or a legal person, such as a corporation.

138. See Rooney & Suit, *supra* note 135, at 675.

139. For example, in the United States, if a taxpayer reaches a final settlement

tent authority to resolve issues of taxation between the state of the competent authority and another state or states can and often does create a situation of conflict of interest for the competent authority.¹⁴⁰

In the United States, the competent authority has the discretion to initiate, continue, refuse, or terminate assistance without the consent or knowledge of the affected taxpayer, the entity requesting assistance, and without resolving the original issue(s).¹⁴¹ In fact, under the terms of the tax treaties, the U.S. competent authority has broad discretion and may even reach an agreement with a treaty partner on a basis inconsistent with U.S. tax laws or regulations.¹⁴²

In the Japanese system, the competent authority procedure exists only due to treaty, and any domestic laws incorporating competent authority provisions merely implement the treaty-related powers.¹⁴³ No provisions exist under current law or regulations for unilateral adjustments in Japan solely to prevent double taxation.¹⁴⁴ Therefore, in a double taxation situation, absent mutual agreement between competent authorities of Japan and a treaty partner, it is unlikely that a taxpayer would receive unilateral relief from the Japanese authorities.¹⁴⁵

with the I.R.S. field or Appeals on a potential competent authority issue, the competent authority will not change the agreement if a corresponding adjustment cannot be reached with the competent authority of the treaty party. *See* Rev. Proc. 96-13, 1996-3 I.R.B. 31; *see also* Hannes et al., *supra* note 38, at 680 (explaining that the taxpayer must be strategic in sequencing pursuit of relief).

140. *See* Rooney & Suit, *supra* note 135, at 676.

141. *See* Venuti et al., *supra* note 132, at 230.

142. *See id.* at 230. The competent authorities can reach agreement on adjustment without agreement on methodology; *see* Donmoyer et al., *supra* note 53, at 894 (reporting a statement of Frank Y. Ng, Director of the IRS Tax Treaty Division).

143. For a clear explanation of the extent and sources of power of competent authorities in Japan, as well as procedural aspects and considerations for filing for competent authority relief, *see* Boidman et al., *supra* note 106, at ch. 33.

144. *See id.* at ch. 33, V.A..

145. *See id.* (citing as the authoritative source for this contention); HAYUKA, M., ITEN KAKAKU ZEISEI SHOUKAI [A DETAILED EXPLANATION OF THE TRANSFER PRICING TAX SYSTEM] 97 (Okura Saimu Kyokai, 1991).

In a recent survey, more than half of all U.S. multinational corporations responding consider the competent authority procedure unsatisfactory; for Japanese multinational corporations, slightly less than one-third found the competent authority procedure wanting.¹⁴⁶ The major reasons given for dissatisfaction regarded the length of time involved in the process and the fact that, at the end, there is no guarantee that an agreement will be reached.¹⁴⁷ Nevertheless, both U.S. and foreign competent authorities are requiring even more extensive documentation from taxpayers if they want relief from double taxation.¹⁴⁸ However, the IRS and the NTA have specifically sought to expedite double taxation relief by developing a process to allow U.S. taxpayers being audited in Japan to apply immediately to the U.S. competent authority, which could in turn initiate talks with the Japanese competent authority.¹⁴⁹

B. INTERNATIONAL USE OF ADVANCE PRICING AGREEMENTS

Advance Pricing Agreements provide a means for business entities to reach a formal agreement with the competent authorities of the states having potential tax jurisdiction over a given set of transactions. According to revenue authorities from countries having some form of APA process, potential benefits to multinational corporations include: bringing more certainty and predictability to tax treatment of transfer pricing situations, limiting costs and time spent in examination, and reducing the possibility of litigation.¹⁵⁰ Benefits of APAs to the authorities, according to them, included: a better understanding of a multinational corporation's business, increased certainty that the correct amount of tax is paid, and a better working relationship between tax authorities of different nations.¹⁵¹

146. Ernst & Young, *Transfer Pricing*, *supra* note 2, at 303.

147. *Id.* at 304.

148. See, e.g., *Competent Authorities Warning Taxpayers To Provide More Extensive Documentation*, *Transfer Pricing* (BNA) at 124 (July 3, 1996).

149. This could allow resolution of double taxation issues prior to deficiencies being paid. See *U.S.-Japan Process Would Allow Relief For Taxpayers Under Japanese Audit*, *ACI Says*, *Transfer Pricing* (BNA) at 99 (June 21, 1995).

150. Ernst & Young, *Transfer Pricing*, *supra* note 2, at 295. For a discussion of APAs in the United States, see *supra* Section III.B.3..

151. See Ernst & Young, *Transfer Pricing*, *supra* note 2, at 295.

In order for APAs to be feasible internationally, both the business entities and the competent authorities of the states involved must be able to understand and bridge the taxation differences between the respective systems. Japan and the United States are both members of the Pacific Association of Tax Administrators (hereinafter PATA).¹⁵² The PATA has taken a number of steps in order to facilitate the handling of tax matters between and among the member states. PATA members agreed upon expedited exchange of information guidelines in order to facilitate tax examinations.¹⁵³ PATA developed and instituted broad procedural guidelines in order to facilitate the competent authority portion of obtaining bilateral APAs.¹⁵⁴ The members have continued coordination of their APA systems in order to better coordinate and handle the increasing number of APA applications.¹⁵⁵

Usage of APAs by multinational business entities has increased dramatically in the past ten years, and many multinational corporations expect the use of APAs to increase further.¹⁵⁶ In fact, the majority of advance pricing agreements currently approved by the IRS are bilateral or multilateral agreements involving the IRS and the tax authority of one or more foreign governments.¹⁵⁷ A number of Japanese firms are actively pursuing APAs with the IRS.¹⁵⁸

152. The other members are Australia and Canada.

153. See Miyatake, *supra* note 31, at Japan 51.

154. See *Japanese Banks Seeking Bilateral APAs*, *supra* note 31, at 204; see also Julianne MacKinnon, *IFA's U.S. Branch Considers Recent Worldwide APA Development*, 9 TAX NOTES INT'L 1815 (Dec. 12, 1994) (indicating that, as of that date, the U.S. had reached agreement with Canada, Australia, and Japan).

155. See *Pacific Rim Tax Administrations Discuss Transfer Pricing Issues*, Transfer Pricing (BNA) at 346 (Oct. 18, 1995); see also *Bilateral Advance Pricing Agreements*, 12 TAX NOTES INT'L 1589 (May 20, 1996) [hereinafter *Bilateral Advance Pricing Agreements*] (citing speech of Michael Durst, director of the U.S. APA program; noting also total of 125 completed APAs in U.S. as of May, 1996).

156. In an international study of multinational corporations: 81% expected the use of APAs to increase, and almost 50% believed that they would enter into one in the future. See Ernst & Young, *Transfer Pricing*, *supra* note 2, at 295.

157. As of May, 1996, 80% of the 125 APAs were bilateral or multilateral, an increased ratio over 50% in August, 1994. See *Bilateral Advance Pricing Agreements*, *supra* note 154, at 1589.

158. See, e.g., *Pre-Confirmation System To Be Made Law*, *supra* note 110, at 94 (practitioners estimate that, as of June, 1996, about 20 large Japanese taxpayers have requested U.S. APAs); see also *Hitachi Expected To Receive U.S. APA*, *Company, Japanese Tax Sources Say*, Daily Tax Rep. (BNA) No. 99, at G-2-G-3 (May

There are several major issues with the use of APAs from a business point of view. One of the major drawbacks to APAs, as seen by both U.S. businesses and businesses of other countries, is the requirement of disclosure of sensitive information.¹⁵⁹ Another major drawback consists of the time and cost involved in preparing an international APA.

Apple Computer was the first multinational corporation to enter into an advance pricing agreement regarding transfer pricing with the tax authorities of two jurisdictions, the United States and Australia.¹⁶⁰ To date, Apple Computer, Inc. has used advance pricing agreements with several of its foreign subsidiaries, including Australia, Canada, Singapore, as well as the first by a U.S. parent company between the IRS and Japan's National Taxation Authority. The total cost of Apple's Australian APA was approximately \$200,000.¹⁶¹ Although experience and data accumulated should reduce the costs of an APA, each will require significant tailored research; preparation of Apple's APA included examination of pricing arrangements between Apple and Apple Japan, comparable transactions, and entities.

For the future, the United States and Japan are working together not only to reduce the costs involved in the preparation of APAs, but also to encourage and facilitate the usage of APAs. One milestone in easing the difficulty caused by the different transfer pricing approaches occurred recently when the NTA and the IRS granted an advance pricing agreement to Komatsu, a Japanese firm with a U.S. unit, based on a hybrid of the transfer pricing methodologies preferred by each.¹⁶²

22, 1996). Matsushita Electric Industrial Co., Fuji Bank Ltd., and Sumitomo Bank Ltd. of Osaka have obtained U.S. APAs. See *Japanese Banks Seeking Bilateral APAs*, *supra* note 31, at 204.

159. In a survey of 210 multinational corporations representing 11% of the Global 1000, this was found to be the major disadvantage of APAs from their perspective. For this study of multinational corporations and their usage, concerns, and beliefs regarding APAs, see Ernst & Young, *Transfer Pricing*, *supra* note 2, at 297.

160. This agreement took place before the advent of the U.S.' formal program for APAs. See *id.* at 294.

161. Internal time was estimated at about 1200 hours total. External consultants' fees were \$50,000 to \$150,000 for each original submission. As of 1994, Apple's IRS User Fees were \$10,000. See *id.* at 310.

162. The two methodologies are the comparable price method preferred by the

C. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD)

The Organization for Economic Cooperation and Development has been involved in the issue of taxation and reconciling tax issues between states. In 1977, the OECD issued a model treaty as an international standard for income tax treaty negotiations.¹⁶³ The members of the OECD took an early and firm stance on transfer pricing, declaring that: “[e]nterprises should refrain from making use of the particular facilities available to them, such as transfer pricing which does not conform to an arm’s length standard, for modifying in ways contrary to national laws the tax base on which members of the group are assessed.”¹⁶⁴

In 1979, the OECD produced transfer pricing guidelines, which are being revised to reflect current developments in transfer pricing and to serve as guidelines in the international tax arena.¹⁶⁵ A representative of the U.S. Treasury noted that it “is difficult to over-emphasize the importance of these guidelines,” describing them as “the consensus interpretation of the arm’s length standard,” and noting their usage and acceptance

IRS and the profit split method used by NTA. See *U.S.-Japan Tax Authorities Agree to First ‘Hybrid’ Methodology APA For Japanese Firm*, Daily Tax Rep. (BNA) No. 95, at G-1 (May 16, 1996).

163. See Donald A. Finlayson, *U.S. Source Income Earned by Foreign Branches and Affiliates*, 47 TAX LAW. 349, 362 (1994); see also Model Tax Convention on Income, *supra* note 100. The OECD Model was revised in 1992 and again in 1995.

164. Declaration by the Governments of OECD Member Countries and Decisions of the OECD Council on International Investment and Multinational Enterprises, June 21, 1976, Annex-Taxation (2), as amended in 1979 and 1984, OECD, INTERNATIONAL INVESTMENT (rev. ed. 1984) reprinted in 2 BASIC DOCUMENTS OF INTERNATIONAL ECONOMIC LAW 565, 570 (American Society of Int’l Law ed., Commerce Clearing House 1990).

165. See Samuels, *supra* note 28, at 64. For some of the diverse views of the OECD Transfer Pricing Guidelines from different national perspectives, see, e.g., Toshiaki Katsushima, *Perspective: OECD Transfer Pricing Guidelines*, 6-7 INTERTAX 273 (1995); ASSOCIATION OF GERMAN CHAMBERS OF INDUSTRY AND COMMERCE FEDERATION OF GERMAN INDUSTRIES, *Comments on OECD Transfer Pricing Guidelines, Part I-Discussion. Draft*, 2 INTERTAX 93 (1995); FEDERATION DES EXPERTS COMPTABLES EUROPEENS (Press Release), *FEE Comments on Discussion Draft of Part I of the OECD Transfer Pricing Guidelines*, 2 INTERTAX 104 (1995); ICC *Comments on OECD Transfer Pricing Guidelines for MNEs and Tax Administrations - Discussion Draft of Part I*, 1 INTERTAX 39 (1995).

in U.S. bilateral tax discussions.¹⁶⁶ Experts in the area of taxation and transfer pricing agree that "there will be a greater role for organizations like the Organization for Economic Cooperation and Development than organizations based in one country such as the IRS of the United States."¹⁶⁷

Internationally accepted standards for transfer pricing will promote the efficiency and effectiveness of transfer pricing regulation and negotiations by and between states.¹⁶⁸ For example, the United States and Japan are moving toward a closer consensus based not only on their bilateral negotiations, but also on their mutual involvement in the OECD. The IRS and the U.S. Treasury worked with the OECD to ensure that the OECD interpretation of the arm's length standard and the I.R.S. Regulations interpretation are consistent.¹⁶⁹ In fact, the U.S. Treasury's position is that "there is no substantial difference between the U.S. and the OECD guidelines."¹⁷⁰ The Japanese transfer pricing regime, as discussed above, was originally based on the OECD work. The serious involvement of a number of states in the development and extension of the OECD model for transfer pricing, although fraught with a certain level of disagreement, clarifies, if not international guidelines, at least areas of disagreement.

V. ALTERNATIVE SOLUTIONS TO BE CONSIDERED

A. FORMULARY APPORTIONMENT

While there are variations on the formula used, the most basic formula approach to taxation compares property, payroll,

166. See Samuels, *supra* note 28, at 65.

167. See O'Connor, *supra* note 6, at iv.

168. This is indicated by the amount of time spent by and between states interpreting and negotiating differences in tax policies and accounting principles. These negotiations are not only time-consuming, but also not always successful. Differences in the tax policies and customary practices of Japan and the U.S. and the resulting differences in interpretation of pricing and costs are cited as the predominant factors in competent authority negotiations between the U.S. and Japan in the last decade. See *Some 20 Cases in U.S.-Japan Negotiations But Several At Stalemate*, Sources Say, Daily Tax Rep. (BNA) No. 34, at G-1 (Feb. 21, 1995).

169. See Birnkrant & Croker, Jr., *supra* note 15, at 268.

170. See *Bilateral Advance Pricing Agreements*, *supra* note 154, at 1589 (quoting Michael Durst, director of the APA program).

and sales in each country where a business operates. One suggestion for formulary apportionment is worldwide unitary apportionment based on the California model.¹⁷¹ The states of the U.S. use formulary apportionment to allocate income earned by multistate businesses between the states.¹⁷² The formulary approach determines the overall worldwide profits of an entity and allocates it to countries based on a mathematical formula.¹⁷³

This method has been considered as a solution by many authors and is being studied by officials in the United States,¹⁷⁴ although not supported by many involved in transfer pricing, including members of the Treasury.¹⁷⁵ California's worldwide unitary apportioning method was upheld by the U.S. Supreme Court which held that it was "fairly apportioned, nondiscriminatory, fairly related to the services provided by the State, and that its imposition did not result inevitably in multiple taxation."¹⁷⁶

Worldwide unitary apportioning is advocated on the theory that it is a more effective means for taxing multinational corporations which are inherently interdependent.¹⁷⁷ A benefit of the unitary system to taxpayers is non-interference with transfer pricing or financial decisions of the taxpayers.¹⁷⁸ In order for worldwide unitary apportioning to be successfully implemented, wide-scale support and change would be essential.¹⁷⁹

171. See Tyson, *supra* note 126, at 35.

172. Michael S. Schadewald, *Global Apportionment: How Would It Affect the Largest U.S. Corporations?*, 12 TAX NOTES INT'L 131 (July 8, 1996).

173. For examples and explanations of how variations impact the outcome, see *id.* at 135-137; see also *Multinationals Concerned About Treasury Conducting Study for Dorgan*, 159 Daily Tax Rep. (BNA), Aug. 17, 1995, at G-3 [hereinafter *Multinationals Concerned About Treasury Conducting Study*].

174. The General Accounting Office issued a report on the possibilities of using a formulary system for the United States at a national level, and the Treasury Department is also preparing its own study. See e.g., *Multinationals Concerned About Treasury Conducting Study*, *supra* note 172, at G-3; see also Schadewald, *supra* note 171, at 131 (presents a study representing the differences in taxable U.S. profits for 1994 of 50 of the largest U.S. corporations using the formulary method versus arm's length transfer pricing).

175. See, e.g., Samuels, *supra* note 28, at 67.

176. *Barclays Bank PLC v. Franchise Tax Bd.*, 114 S. Ct. 2268, 2278 (1994).

177. See Tyson, *supra* note 126, at 47.

178. See *id.* at 51.

179. See *id.* at 48; see also Samuels, *supra* note 28, at 67.

Formulary apportionment is opposed by many multinationals as causing double taxation of foreign earned income¹⁸⁰ and creating additional compliance and administrative burdens.¹⁸¹ It is also strongly opposed by the OECD draft report on Transfer Pricing as difficult to implement due to the need for consensus as to a formula and the numerous accounting factors used therein.¹⁸²

Any formula approach to analyzing pricing, by its nature, neglects to consider reasons other than tax manipulation for non-arm's length prices between related entities.¹⁸³ A fair examination to determine the existence of abusive transfer would require examining a number of other potential reasons for differential pricing practices. These include a number of general business reasons, such as market penetration, associated products, and valued long-term business relationships, among others. A number of cultural reasons could also account for differential pricing policies between parties which are related, including, among others: family ties, tradition, valued long-term relationships, and supporting the business efforts of an economically less competitive entity due to affiliation, relationship, or friendship. The formulary approach does not always allocate taxation consistent with reality or fairness.

The fundamental difference between arm's length method and formula method is that the former must be determined for each operation, whereas the formula method uses the taxpayer's average internal rate of return on its worldwide

180. See, e.g., *Multinationals Concerned About Treasury Conducting Study*, *supra* note 172, at G-3 (quoting Dave Jory, tax attorney for Citicorp as saying that Citicorp opposes formulary apportionment as it "would virtually guarantee double taxation of our income earned abroad.").

181. See, e.g., *id.* at G-3 (quoting Alex Spitzer, senior vice president of taxes at Nestle).

182. See Samuels, *supra* note 28, at 67 (positing that, due to the extent of the differences and definitions to be reconciled, a Multinational Tax Commission of some form would be required, with concordant delegation of some domestic tax policy).

183. See Lodin, *supra* note 27, at 240 (discussing the United States' 1992 proposed regulations, Sven-Olof Lodin, a professor and policy advisor to Swedish industry, comments that the proposed regulations "represent an endeavor for fiscal perfectionism, which seems to forget that transfer prices are generally based on business purposes and not the avoidance of US taxes.")

operations.¹⁸⁴ Several specific business factors which can cause the results of formulary apportionment to differ greatly from an arm's length analysis include: varying exchange rates,¹⁸⁵ differences between the products and services produced and sold in various countries, labor costs, customer preferences, local economic conditions, and other location-specific factors.¹⁸⁶

B. INTERNATIONAL TAXATION SYSTEM

One possible solution to facilitate the effective and efficient administration of taxation of international transactions would be to implement an international taxation system. The international community has long recognized that the governance of multinational business requires at least multinational agreement, if not a multinational governing body or bodies. Issues of sovereignty sometimes impede the multinational/multilateral regulation of business practice, but pragmatism and growing international interdependence encourage and require the continued development and application of international private law to multinational business activities. However, taxation is still considered a sovereignty issue which may allow for bilateral or multinational discussion, but remains a decision of each nation.

One theory is that: "[T]he Nation State has become an unnatural, even dysfunctional, unit for organizing human activity and managing economic endeavor in a borderless world . . . it overlooks the true linkages and synergies that exist among often disparate populations by combining important measures of human activity at the wrong level of analysis."¹⁸⁷ Although the role of international law continues to grow in the world community and plays an increasing role within nations, tension remains between a nation's desire for sovereignty and the facilitation provided by international law.

184. See Schadewald, *supra* note 171, at 132.

185. See Tyson, *supra* note 126, at 43.

186. See Schadewald, *supra* note 171, at 137-138.

187. Kenichi Ohmae, *The Rise of the Region State*, 72 FOREIGN AFFAIRS 78 (1993) (arguing that the economy is undeniably global in nature, made up of regions and states sharing certain economic and consumer interests).

However, the trend, particularly in the second half of the twentieth century, has been for countries to forsake an increasing amount of sovereignty for international development and stability. International law is developing increased presence and importance in many realms of life, including, among others: human rights, peace and war, maritime activities, environment, politics, developmental issues, and, due to its enormous impacts on the world community and across state boundaries, international business.¹⁸⁸

Although the harmonization of effective corporate rates among nations would preclude the use of corporate income taxation as a national policy tool,¹⁸⁹ hopefully, the growing body of bilateral treaties, multilateral guidelines, agreements, and conventions on the subject of transfer pricing embodies growing consensus within the international community. The rapid development of international standards, conventions, understandings, and practices regarding transfer pricing could arguably be construed as international law, although it has not been recognized as such. Outside of taxation, nations, business entities, and individuals are increasingly required to be familiar with and respect international private law as it applies to multinational business interests and the entities which develop, interpret, and apply it. In order to truly address the issue of appropriate taxation in the face of transfer pricing, nations and the international community as a whole must reach agreement(s) as to the purpose of this taxation and design taxation process(es) to accomplish the purpose(s).

The possible advantages of an international tax system are many. A tax with a single form for the international tax administration would require the taxpayer to comply with one set of document and information requests. Additionally, compliance with a single set of rules would be easier to figure out without the juggling necessary to maintain consistency with several regimes simultaneously.

188. For a discussion of the rapidly increasing body and importance of international trade law as it intersects with American trade law, and the resulting gaps and difficulties, see generally Garten, *supra* note 20, at 15.

189. See Tyson, *supra* note 126, at 49.

An international tax administration should prove not only less costly, but also much easier from a state governmental point of view. The international tax administration could handle apportionment of funds. An impartial international body could not only be neutral, but also reduce costs by its neutrality and result in fairer results for poorer nations by providing them with a certain sum of income, which they may not have the administration or the might to collect on their own.

C. FLAT TAX

The use of a flat (or uniform rate of) tax would not address the individual nature of each transaction, but, in not doing so, it would eliminate a phenomenal amount of administration and research costs for both the taxpayers and the tax administrations involved. There is a desire to use precedent in order to be just and to facilitate the development of a body of transfer pricing law. However, in the area of taxation, there are not only issues of confidentiality and proprietary information,¹⁹⁰ but also the fact that each case is truly unique.

A flat tax would ease the difficulty of compliance with transfer pricing regulations, which is incredibly burdensome for tax administrative bodies and for taxpayers.¹⁹¹ The major cost component and area of disagreement in resolving transfer pricing issues are the determinations of the existence and extent of abusive transfer pricing. The determination of proper pricing is by its definition very complex,¹⁹² an accurate analysis of pricing requires an understanding of: the industry; the relationships; the competitors; fluctuations and developments in, and history of the market; an understanding of the relationships and goals involved in a set of transactions; and the ability to accurately discern the profit margin. The determination

190. In a survey of 210 multinational corporations representing 11% of the Global 1000, this was found to be the major disadvantage of APAs from their perspective. See Ernst & Young, *Transfer Pricing*, *supra* note 2, at 307.

191. Cf. Wolosoff, *supra* note 38, at 706; see also *Taxpayers Should Not Rush into Studies for §6662 Purposes*, *supra* note 58, at 111 (quoting Alan O. Dixler, Merck & Co.'s senior tax counsel, as stating that transfer pricing compliance can be summed up by the acronym SARA: "shock, anger, rejection, and acceptance.").

192. For a succinct entertaining criticism of transfer pricing methodologies, see O'Connor, *supra* note 6, at ix-xi.

of profit itself is complex and allows for such an array of different results that profit is a nebulous basis for payment in a contract situation and certainly in a taxation system. The determination of whether or not parties are related is time-consuming and often impossible to determine with accuracy.¹⁹³ The time involved in researching transfer pricing for intangibles is phenomenal and usually ends up being based on subjective comparisons and analyses.¹⁹⁴

The problems with trying to state every possible issue is seen by the proliferation of the regulations, treaties, conventions, and administrative bodies with little resulting clarity. This issue is likely to become exacerbated as an increasing number of smaller companies have access to and participate in international markets and face possible transfer pricing issues.¹⁹⁵ A flat tax would eliminate the enormous, increasing amount of time, staff, and money required of taxpayers and tax administrations in order to handle transfer pricing issues¹⁹⁶

VI. CONCLUSION

A systemic analysis of taxation of entities involved in international business requires examining stakeholders in the global marketplace as a whole, the goals of each, the current structures, systems and processes in place, and how these do

193. *Apple Computer Completes Bilateral U.S.-Japanese APA*, Daily Tax Rep. (BNA) No. 164, at G-2 (Aug. 24, 1995).

194. The OECD report notes that establishing comparables for determining arm's length pricing for intangibles must include a careful consideration of several factors which affect comparability: the potential profits from use of intangible property, any geographical limitations on usage, any restrictions on exportations of goods, exclusivity of the rights transferred, and whether the licensee has rights to the licensor's further developments of the intangible property. See Marc M. Levey & Lawrence W. Shapiro, *OECD Transfer Pricing Draft Targets Excessive Documentation*, 6 J. INT'L TAX'N 244, 245 (1995).

195. The temporary § 482 regulations addressed the issue of a small business safe harbor, based on computing transfer prices according to profit level indicators to be published by the Service. The final regulations did not include a safe harbor due to concerns by the Service and foreign treaty partners that the safe harbors might be misapplied or result in inaccurate reporting of income. See Hirsh et al., *supra* note 33, at 593.

196. TAX POLICY AND ADMINISTRATION ISSUES, *supra*, note 4, at L-1 (estimating that IRS examiners, economists, and appeals staff spent about 186 staff years on cases related to transfer pricing closed in fiscal 1993 and about 227 staff years on those closed in fiscal year 1992).

or do not interact and function. Theoretically, the goal of taxation is that the total tax paid by each entity represents a fair and reasonable contribution of a portion of income towards the maintenance of the system or a part thereof. In an ideal system, there would be an equitable distribution of tax between jurisdictions. A well-designed tax system would motivate investment and development that would support international goals regarding development, the environment, and society, to name a few.

The inherent weaknesses of tax models and model structures in general are their single dimensionality and inadequate feedback. Like most models, tax models do not take adequate cognizance of evolution within a system. The structure of a model is often unable to adjust for changes in the external environment.

As the cost to the state of getting the revenue is exorbitant and becoming more so, while the efficacy of doing so is limited, other less cumbersome solutions should be and are being explored. Aside from the jurisdictional issues causing overlapping taxation, the body of tax law and regulations designed by nations to tax "their share"¹⁹⁷ of international transactions is complex, overwhelmingly detailed, cumbersome, expensive, confusing, and time-consuming to apply. The tax administrations must design rules and mechanisms to analyze and verify the reality of pricing strategies between entities, which may or may not be designed to minimize or eliminate taxation. Also, nations must resolve whether and how to work with other nations to resolve, reconcile, or compromise on administering and resolving issues of double taxation.

In a perfect solution, income would only be taxed once by the jurisdiction where that income is being produced; however, the location of income generation is often ambiguous and difficult to ascertain with certainty. Additionally, the determination of whether the transfer price actually reflects the income generated is more difficult to assess than is immediately ap-

197. The national tax authorities represent the interests of their own nations and the interpretations and applications of transfer pricing regulations which will benefit their nations. See Lodin, *supra* note 27, at 240.

parent. In assessing pricing between related entities, many countries look to comparable transactions; but, is the "real price" what another entity would charge an unrelated entity? Pricing is done for tax reasons, but also for other reasons, including: growth strategy, capturing a market, introduction of a product/service, capturing other related markets (e.g. cellular telephones for \$1), and the creation of future consumers.

It would seem logical that to eliminate transfer pricing issues, either the tax to be assessed must be based on "non-fudgeable criteria" or taxation should be by one entity internationally, with an effective and equitable distribution to the specific nations. The plethora of codes, regulations, rules, and administrators indicates the difficulty of doing so under the arm's length standard now applied. Given that it is currently estimated that almost half of all trade among the more developed nations takes place between related parties,¹⁹⁸ ascertaining a true arm's length price may be difficult or impossible. However, one U.S. Treasury official sums up the debate as to international transfer pricing methodologies: "[T]he primary advantage that the arm's length standard currently enjoys in relation to formulary apportionment is the simple fact that most of the world agrees that it should be the international norm."¹⁹⁹

In the international realm, since trade has been seen to require multilateral treaties, then why not taxes? From the point of view of the taxpaying business entities, some certainty or confidence as to tax treatment would help in their short- and long-term strategic and financial planning. Yet, the administration and collection of tax revenue where transfer pricing is involved are far from consistent. From a state point of view they are far from successful, and the role of tax policy as a force for development or change has been lost. Even if taxation was done on an international level or according to some harmonized taxation scheme, tax could be used to encourage domestic or international policies through means other than the amount assessed, such as rebates or industry specific application of revenues. However, the key problem with the cur-

198. See Ernst & Young, *Transfer Pricing*, *supra* note 2, at 299.

199. See Samuels, *supra* note 28, at 68.

rent state of transfer pricing regulation as epitomized by the American approach is that it pays little or no attention to the fact that the transfer pricing problems are general international problems affecting many countries and that this must be taken into account when formulating the rules.²⁰⁰

200. Lodin, *supra* note 27, at 240.

