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INTERCOMPANY TRANSFER PRICING REGULATIONS UNDER INTERNAL REVENUE CODE SECTION 482: THE NOOSE TIGHTENS ON MULTINATIONAL CORPORATIONS

TECHNIX V. COMMISSIONER¹

International Technix, Inc. (Technix), a worldwide leader in the manufacture and sale of sophisticated electronic components, is preparing its federal income tax return for 1994. Under the regulations of Internal Revenue Code § 482 issued on July 8, 1994, Technix has a choice of five or more equally appropriate and legal methods for computing its income. However, Technix determines that each of these methods results in a different taxable income. Technix decides to choose the accounting method that results in the lowest taxable income because, as the United States Supreme Court has acknowledged, taxpayers have the right to use all of the options available in the tax regulations to reduce one's taxable income.²

After studying the Technix tax return, the Internal Revenue Service (IRS) asks to see the analyses Technix prepared in determining the accounting method ultimately selected. In addition, the IRS asks to inspect analyses of the income tax computations based upon the other allowable methods Technix did not choose. Technix submits more than 22,000 pages of financial and economic analysis to the IRS. Following its review, the IRS concludes that the method chosen, though legal, resulted in the lowest taxable income of the various options available. The IRS decides Technix should have selected the method that would have resulted in the highest taxable income. The IRS then demands that Technix pay not only additional tax and interest, but also significant penalties because the IRS claims Technix did not select the

1. International Technix, Inc., is a fictitious corporation. The hypothetical example illustrates the problems U.S. corporations face when interpreting the regulations under Internal Revenue Code § 482.

2. *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). Judge Learned Hand wrote, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." *Id.*

"correct" transfer prices.

Technix argues that this is not fair. After all, if Congress did not want the company to have the option of the accounting method selected, Congress would not have made it available. The IRS counters that, while it is true Congress wanted Technix to have the option selected, the IRS's option is "better" because the IRS is responsible for assessing and collecting federal income taxes. Technix also argues that there were other excellent business reasons for choosing the selected method. The IRS responds that these are not sufficiently good reasons. Technix concludes the IRS's position is unjust and unfair, and decides to seek justice through the courts. Technix must prove that the IRS computed the tax in an arbitrary and capricious manner, a difficult burden to sustain.³ After protracted litigation, the IRS loses. Although satisfied with the court's verdict, Technix spent one million dollars to litigate the matter.

INTRODUCTION

The hypothetical example above indeed happens.⁴ In fact, recent changes in United States tax regulations, intended to clarify the tax rules, actually result in further confusion.⁵ As a result of this confusion, more litigation between the IRS and multinational companies will occur, rather than less.⁶ This Note addresses how the new IRS § 482 regulations impede international trade and commerce. Part I of this Note demonstrates how IRS

3. The taxpayer's burden is increased by the fact that IRS assessments are presumed to be correct. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Niles Bement Pond Co. v. United States*, 281 U.S. 357, 361 (1930); *Cohen v. Commissioner*, 266 F.2d 5, 11 (9th Cir. 1959). Under the U.S. system of self-reporting of tax liability, the taxpayer determines the amount of tax payable, because only the taxpayer possesses the objective evidence to determine the tax liability. The only information the IRS has to establish whether the taxes payable are correct is the information filed with the company's tax returns. A number of tax cases support the allocation of the burden of proof to the party possessing the evidence. *United States v. Rexach*, 482 F.2d 10, 16 (1st Cir.) (shifting burden of proof onto taxpayer based upon "likelihood that taxpayer will have access to the relevant information"), *cert. denied*, 414 U.S. 1039 (1973); *Llorente v. Commissioner*, 74 T.C. 260, 274 n. 3 (1980) (Tannenwald, J., concurring) (quoting *Rexach*, 482 F.2d at 16).

4. See, e.g., *Seagate Technology Inc. v. Commissioner*, 102 T.C. 149 (1994); *National Semiconductor Corp. v. Commissioner*, 67 T.C.M. (CCH) 2849 (1994); *Exxon v. Commissioner*, 66 T.C.M. (CCH) 1707 (1993); and *Perkin-Elmer v. Commissioner*, 66 T.C.M. (CCH) 634 (1993). See *infra* Part III for a discussion of these cases.

5. See *infra* notes 86-115 and accompanying text for a discussion of the problems in practical application of the IRS regulations on sales prices to related parties.

6. See *infra* notes 162-236 and accompanying text for a discussion of recent tax cases concerning selling prices between related business entities and how the new IRS regulations are apt to lead to increased litigation.

pricing regulations that hinder the ability of United States and foreign firms to compete in today's global market are inconsistent with the economic interests and stated policy of the United States.⁷ Part II describes and analyzes several of the principal elements of the new IRS regulations and the onerous new burdens created by the regulations.⁸ Part III explores four recent Tax Court cases involving IRS reallocations for the pricing of international goods and services. This Part also examines how the new regulations will likely result in more litigation to determine transfer price allocations.⁹ Finally, Part IV of this Note proposes changes in the regulations to create a more workable environment for both multinational taxpayers and the IRS.¹⁰

I. THE NEW IRS REGULATIONS ARE INCONSISTENT WITH THE ECONOMIC INTERESTS AND STATED POLICY OF THE UNITED STATES

This section examines the increasingly international nature of the market. It describes how American and foreign firms are expanding globally, and considers why foreign multinational firms have expanded their investments in the United States faster than American firms have expanded abroad.¹¹ This section also discusses reasons why the internationalization of business will continue and why United States government policy must work to aid and not to hinder such economic expansion.¹² Finally, this section explores how IRS regulations issued on July 8, 1994 unfairly impact and hinder both American firms operating internationally and multinational firms seeking to expand in the United States.¹³

7. See *infra* notes 11-80 and accompanying text for a discussion of how IRS pricing regulations place onerous new burdens on United States firms and foreign firms, hindering their ability to compete in the market.

8. See *infra* notes 81-161 and accompanying text for a discussion of the principal elements of the new IRS regulations.

9. See *infra* notes 162-236 and accompanying text for an analysis of four recent Tax Court cases involving IRS reallocations for the pricing of international goods and services.

10. See *infra* Part IV for a discussion of suggested changes in the IRS regulations to reduce the difficulties taxpayers encounter in applying the regulations.

11. See *infra* notes 14-63 and accompanying text for a discussion of why American and foreign firms are expanding globally, and why foreign multinational firms have expanded their investments in the United States faster than American firms have expanded abroad.

12. See *infra* notes 14-39, 64-80 and accompanying text for a discussion of how United States government policy hinders expansion of American firms abroad.

13. See *infra* notes 64-80 and accompanying text for a discussion of how newly issued IRS regulations unfairly impact and hinder both American firms operating internationally and multinational firms seeking to expand in the United States.

A. *American Firms Involved in Profitable International Business Create Wealth and Jobs*

The policy of the United States government is to aid and not to hinder efforts by American businesses to expand their international operations.¹⁴ Businesses committed to international markets tend to develop both superior profits and deeper problem-solving and managerial expertise, which result in significant competitive strengths creating additional profits, wealth and jobs.¹⁵

14. GEORGE H.W. BUSH, AGENDA FOR AMERICAN RENEWAL 5 (1992). The policy of the United States government to aid American businesses expanding internationally receives bipartisan support. *Id.* During the 1992 presidential campaign, former President Bush said that the U.S. economy was undergoing profound changes, the most far-reaching of which was the recognition that no nation is an island, and all are part of the global economy. *Id.* He noted that international economic interdependence had a number of implications:

[I]f America is going to be strong and growing in the 21st Century, we must be ready, able and willing to compete around the globe. We need to encourage entrepreneurial capitalism and investment at home, and at the same time ensure that our labor force remains the best in the world[.] . . . [W]e need to seize opportunities to develop new markets, particularly in areas that have potential for significant growth in the future. One of the other benefits of the end of the Cold War is the extraordinary potential to expand trade and sales to hundreds of millions of potential customers who not long ago were the captives of our enemies.

Id.

Secretary of Commerce Ron Brown in recent testimony before the Senate Banking, Housing and Urban Affairs Committee said:

[United States government policy] is deeply committed to helping U.S. companies become more competitive in the global economy [and American businesses] are proving every day, from the Pacific Rim to Latin America to the European Union, American workers are the most productive in the world, and American products, services, and technology are in increasing demand in every corner of the globe. We're not afraid to compete with anyone, at home or abroad. As President Clinton has stated, 'Open and competitive commerce will enrich us as a nation . . . it spurs us to innovate. It forces us to compete. It connects us with new customers. It promotes global growth without which no rich nation can hope to grow more wealthy.' And our private sector welcomes the opportunity to compete. It is the private sector that drives the engine of economic growth. [The Department of Commerce's] role is to work with industry, labor, and academia to create a healthy, sustainable foundation on which U.S. companies are able to compete and win in the global economy. . . . The Commerce Department's strategy is to help create the environment and the tools to facilitate productive activity in the private sector . . . through our programs . . . to pursue market openings abroad and vigorously promote American exports.

Secretary Ron Brown, prepared testimony on the Department of Commerce Report *Competing to Win in a Global Economy* before the Senate Banking, Housing and Urban Affairs Committee, in FED. NEWS SERVICE, Sept. 21, 1994, available in LEXIS, News Library, Script File.

15. See *infra* notes 33-39 and accompanying text for a discussion of how businesses committed to international markets develop both superior profits and deep-

Unless United States government policies actively work to keep American companies competitive in the world economy, United States businesses will fall out of the global economic race with other nations.¹⁶ Yet the new IRS regulations turn an already cumbersome international tax environment into one that diverts additional resources and attention away from developing international business and directs those resources toward grappling with the IRS.¹⁷ Ironically, at a time when nations around the globe look to the United States for a model of a free economy, the increased intrusion of United States government regulations has a significant impact on the daily business decisions of American companies operating internationally, and actually serves to hinder their ability to compete globally.¹⁸

Since the end of World War II, American firms have aggressively expanded globally.¹⁹ This international economic expansion has created both wealth and jobs for Americans, and for American firms.²⁰ Global operations help American businesses develop problem-solving capabilities that produce sustained and

er problem-solving and managerial expertise.

16. Secretary of Commerce Ron Brown recognized the importance of United States government policy in creating an overall framework for establishing and developing broad policies that result in new possibilities for U.S. exports. He said, "Exports will create more and better jobs and thereby strengthen our communities[,] . . . leading to higher standards of living." Secretary Ron Brown, prepared testimony on the Department of Commerce Report *Competing to Win in a Global Economy* before the Senate Banking, Housing and Urban Affairs Committee, in FED. NEWS SERVICE, Sept. 21, 1994. See *supra* note 14 for more of Secretary of Commerce Ron Brown's testimony before the Senate Banking, Housing and Urban Affairs Committee.

17. As Chief Justice Marshall observed in 1819, "The power to tax involves the power to destroy." *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 431 (1819). Although *McCulloch* involved interstate commerce questions, Chief Justice Marshall's observation is certainly no less true in international taxation matters.

See *infra* notes 64-80 and accompanying text for a discussion of how the new IRS regulations burden an already cumbersome international tax environment and redirect resources of multinational firms from investment to grappling with the IRS regulations.

18. This is not to urge that the United States government plays no helpful role in improving the economic prospects of its citizens. However, the current Secretary of Labor Robert B. Reich has argued that United States government policy should not focus on improving the profitability of American-owned corporations. ROBERT B. REICH, *THE WORK OF NATIONS* 168 (1991). He argues that such policies do not necessarily result in an improvement of the economic prospects of Americans. *Id.*

19. ARVIND V. PHATAK, *INTERNATIONAL DIMENSIONS OF MANAGEMENT* 4 (4th ed. 1995). Phatak notes, "The 1960s laid the foundations for the massive growth abroad of U.S. multinational enterprises. The growth of that decade far exceeded any achieved earlier by the United States or the other industrialized countries of the world." *Id.*

20. *Id.* at 5. Phatak comments, "U. S. multinationals are now playing the dominant role in the proliferation of U.S. business abroad and in the production and marketing of American products in foreign countries." *Id.*

superior economic growth.²¹ Yet an interminable process of legislating tax laws and regulations upon tax laws and regulations will ultimately prevent United States businesses from remaining competitive in the global market.²²

The level of international business grew dramatically in recent decades.²³ Recent estimates show that twenty percent of the gross world product trades internationally.²⁴ The rate of growth in international trade is twice that of the world economy's growth rate.²⁵ Many of the largest corporations based in the United States derive more than one half of their total revenues from their international operations.²⁶ For example, the Coca-Cola Company is the quintessential multinational corporation, distributing products in over 195 different countries.²⁷ During 1993, Coca-Cola earned approximately seventy-nine percent of its operating income outside of the United States.²⁸ This trend is unmistakable, not only among manufacturing firms such as Coca-Cola, but also among firms involved in service industries.²⁹ For example,

21. Charles R. Taylor & Witold J. Henisz, *The Conference Board, U.S. Manufactures in the Global Marketplace* 11 (1994).

22. Rob Norton, *Our Screwed-Up Tax Code*, FORTUNE, Sept. 6, 1993, at 34. Norton notes, "The U.S. tax system is an unwieldy, inefficient, ungodly mess. . . . It penalizes the very investment we need to create jobs and improve living standards. It makes U.S. companies less competitive internationally and encourages them to expand overseas instead of at home." *Id.*

23. RICKY W. GRIFFIN & RONALD J. EBERT, BUSINESS, 685 (2d. ed. 1991). Griffin and Ebert state, "International business is truly big business in our modern world. The volume of international trade rose almost 2,000% between 1960 and 1985. . . . U.S. corporate investments abroad rose from \$52 billion in 1975 to \$260 billion in 1986 to \$327 billion in 1988." *Id.*

24. V. H. (MANEK) KIRPALANI, INTERNATIONAL BUSINESS HANDBOOK 4 (1990).

25. *Id.*

26. JEFF MADURA, INTERNATIONAL FINANCIAL MANAGEMENT 3 (3d ed. 1992).

27. THE COCA-COLA COMPANY, INC., 1993 ANNUAL REPORT 44 (1994).

28. *Id.* at 46.

29. REICH, *supra* note 18, at 132-33. Reich, in describing the shift in the world economy from high-volume, standardized production to high-value international problem-solving enterprises, provides a number of examples. He writes, for example:

McKinsey, the distinguished consulting firm, . . . comprised over 14,000 problem-solvers . . . worldwide, most of them non-Americans. . . . Other global 'insight partnerships' include those that sell expertise about information technology, like Arthur Andersen, with over 46,000 employees worldwide (of whom only 18,000 are Americans); global advertising and marketing, like the WPP Group (including what were formerly Americans J. Walter Thompson and Ogilvy & Mather), with 21,500 employees in 50 countries; civil engineering (Bechtel, with 29,000 employees in 33 nations); financial services (Morgan Stanley, with 6,000 employees spread out over 18 countries); legal services (Baker & McKenzie, with 3,500 staff employees and 1,500 lawyers in 50 cities around the world, of whom fewer than a third are Americans), and so on: advanced research, public relations, agricultural engineering, software engineering, architecture, and not least, investment

McDonalds currently retails its food products in seventy-three countries and derives forty-five percent of its operating income outside of the United States.³⁰ An increasing number of smaller businesses, too, are seeking to expand in international markets.³¹ Seventy-eight percent of the 43,300 United States firms that export their products have fewer than 100 employees.³²

The Conference Board recently issued a comprehensive report on a broad base of American manufacturers operating in the global marketplace.³³ The study compared the international orientation, strategic approach, and sales and profit performance of 1,250 American manufacturing companies, and determined that a commitment by American firms to operating in the global market is critical to sustained and superior economic growth and profitability.³⁴ The predominance of such firms is threefold. First, sales for American manufacturing companies with no foreign activities were found to grow at a rate one-half the survey average,³⁵ whereas American manufacturing firms with international activities grow faster in every industry and in most size categories than those without.³⁶ Second, American manufacturing firms that engage in the worldwide market tend to be more profitable than those which operate merely in limited geographical areas.³⁷ Third, global operations may create a problem-solving capability that significantly benefits a business's performance.³⁸ For these reasons, the report concluded that the "internationalization" of American manufacturing businesses is irreversible.³⁹

*B. Multinational Companies Expanding in the United States
Contribute to the United States Economy and Foresighted
Economic Policy Encourages Growth In Line With
Domestic Interests*

In recent decades foreign firms have also aggressively expanded internationally, with much of this expansion occurring in the United States.⁴⁰ In fact, foreign multinational firms have in-

banking].

Id.

30. Andrew E. Serwer, *McDonald's Conquers the World*, FORTUNE, Oct. 17, 1994, at 104.

31. MADURA, *supra* note 26, at 3.

32. *Id.*

33. See generally TAYLOR & HENISZ, *supra* note 21.

34. *Id.* at 24.

35. *Id.* at 9.

36. *Id.* at 10.

37. *Id.* at 11.

38. *Id.* at 30.

39. *Id.* at 15.

40. Philip M. Rosenzweig, *The New "American Challenge": Foreign Multination-*

vested in the United States at a higher rate than United States firms have invested overseas.⁴¹ At the end of 1993, the level of foreign investment in the United States had grown to more than \$2.926 trillion,⁴² while American investment abroad totaled \$2.370 trillion.⁴³ The difference of \$555 billion makes the United States the world's largest debtor nation,⁴⁴ a trend not likely to reverse itself anytime soon.⁴⁵ Foreign companies invest in the United States because they view the United States as a secure base for manufacturing and want to use the skills of the world's most productive workforce.⁴⁶ Many European and Japanese firms derive twenty percent or more of their revenues in the United States.⁴⁷

Although some observers note with alarm that these developments demonstrate a growing influence in the United States econ-

als in the United States, 36 CAL. MGMT. REV. 107 (1994). Rosenzweig gives a number of reasons for the explosive investment by foreign firms in the United States. These include the following: (1) shifts in the relative value of the U.S. dollar vis-à-vis foreign currencies that make investment in the United States more affordable; (2) an imperative for foreign-based firms to gain global economies of scale; (3) improvements in both communication and transportation that make affiliated companies in the United States more controllable; and (4) the growing similarity of consumer tastes among people in different parts of the world. *Id.* at n.3.

41. MADURA, *supra* note 26, at 11.

42. Russell B. Scholl, *The International Investment Position of the United States in 1993*, SURVEY OF CURRENT BUS., June 1994, at 71.

43. *Id.*

44. The change from creditor to debtor nation has occurred since 1984, the last year in which the United States was a net creditor country. MILTIADES CHACHOLIADES, INTERNATIONAL ECONOMICS 298 (1990). At the end of 1984, total U.S. overseas investments exceeded foreign investments in the United States by \$3.6 billion. *Id.* The year 1985 was the first year since World War I that the United States became a net debtor nation. *Id.*

45. The United States developed a large and growing deficit in its merchandise and current accounts starting in 1982. DAVID K. EITEMAN & ARTHUR I. STONEHILL, MULTINATIONAL BUSINESS FINANCE 65 (5th ed. 1989). The persistent high level of products imported into the United States requires a large flow of foreign investment into the country to offset the trade imbalance created by the consuming public's large appetite for imports. See CHACHOLIADES, *supra* note 44, at 281-300.

Other commentators have identified the growth of the federal budget deficit as another major cause for the change of the United States to a net-debtor nation, as a large portion of government financing of the debt has occurred with support from foreign investors. MADURA, *supra* note 26, at 38.

46. *Foreign Income Tax Rationalization and Simplification: Hearings on H.R. 5270 Before the Comm. on Ways and Means House of Representatives*, 102d Cong., 2d Sess. (July 21, 1992) at 417 (statements of Organization for International Investment). The United States is also seen as a secure base for research and development because of protection granted to intellectual property. *Id.* Further, the United States is viewed favorably by foreign companies because of the intellectual capital of the faculty, as well as the scientific and research facilities, available at American universities and colleges. *Id.*

47. ROSENZWEIG, *supra* note 40, at 107.

omy by foreign firms and investors,⁴⁸ others note that United States subsidiaries of companies domiciled outside of the United States employed 4.7 million persons as workers.⁴⁹ Foreign multinational firms directly contribute tens of billions of dollars to the economic well-being of the United States.⁵⁰ Foreign multinational firms employ their capital to both create and preserve American jobs, while manufacturing and exporting goods to satisfy both American and foreign consumer needs.⁵¹

When IRS tax regulations particularly target foreign multinational firms, it is tantamount to discrimination based upon the nationality of shareholders. These firms invest in the United States with the expectation that they will be subject to the same laws and regulations, and taxed in the same manner, as American firms. Multinational corporations, however, do not seem to evoke a great deal of sympathy. As a result of the major expansion of international trade, the IRS is seeking to tax what some perceive to be a gross underpayment of tax caused by accounting maneuvers to divert profits out of the United States.⁵² Some members

48. *555.7 Billion Dollar Differential Makes US the World's Largest Debtor*, AGENCE FRANCE PRESS, June 28, 1994, available in LEXIS, News Library, Wires File. Mr. Chimérine, chief economist at the Economic Strategy Institute, said, "We have lost control of our currency and our credit markets to foreigners and speculators." *Id.* He added, "If you keep running huge trade deficits at a time when no one wants to hold dollars, then you are going to put pressure on your currency." *Id.*

49. *Hearings on H.R. 5270*, *supra* note 46, at 425. The Organization also noted that out of the total employment by foreign-owned subsidiaries, U.S. manufacturing subsidiaries employed more than two million workers. *Id.* This total manufacturing labor force equaled 10.8% of the total U.S. manufacturing work force. *Id.* In addition, in 1990, foreign owned companies exported \$91 billion of merchandise from the United States. *Id.* Foreign-owned companies also paid \$24.4 billion in sales and property taxes in 1989, in addition to income and payroll taxes. *Id.*

50. GRIFFIN & EBERT, *supra* note 23, at 690. Griffin and Ebert note, "Foreign firms have also captured a sizable portion of the [United States's] domestic market. Nowhere is this change more evident than on America's highways, where BMWs, Toyotas, and Volkswagens share the road with Chevrolets, Fords, and Chryslers." *Id.*

51. *Hearings on H.R. 5270*, *supra* note 46, at 417.

52. Andrea Mackiewicz, *Clinton's Agenda for MNCs Promises Shift in Emphasis*, BUS. INT'L, Nov. 9, 1992, at 357. In 1985, 17 U.S. subsidiaries of foreign-owned corporations earned \$16.7 billion in receipts in the United States and paid one billion dollars in taxes to the United States. *Id.* By 1989, the same firms had quadrupled their receipts to \$63.6 billion, but total taxes paid to the United States decreased by almost \$600 million. *Id.* The IRS itself admits that 72% of foreign-based multinational firms in the United States paid no U.S. income tax in 1989. *Id.*

But tax enforcement against foreign firms may result in retaliation by foreign tax authorities against multinational companies based in the United States. American multinationals operating in foreign countries may become targets for more aggressive audits. *Id.* at 358. For example, Japanese tax authorities assessed an additional penalty tax bill of 15 billion yen against Coca-Cola's Japanese subsidiary for improper income transfers. Some commentators have suggested the Japa-

of Congress believe that foreign-owned multinational companies underpay their fair share of taxes.⁵³ During the last presidential campaign, President Clinton raised the matter as a campaign issue, and stated that foreign companies operating in the United States evaded large amounts of taxes.⁵⁴ President Clinton prom-

nese decision comes in the midst of increasing concern about efforts of the United States government to secure control over foreign multinational companies that operate in the United States. Emiko Terazono, *Coca-Cola Faces Tokyo Penalty Tax*, FIN. TIMES, Mar. 28, 1994, at 4. The decision by the Japanese tax authorities follows a 1992 IRS ruling that Kawasaki Heavy Industries avoided U.S. taxes; Kawasaki was charged 1.2 billion yen in additional taxes. *Id.* In 1993, Nissan Motor Company paid 17 billion yen in penalty taxes to the United States government, an amount almost equal to that charged by the Japanese tax authorities against Coca-Cola. *Id.*; see also Jonathan Schwarz, *Survey of World Taxation*, FIN. TIMES, May 20, 1994, at III.

53. H.R. 4308, 101st Cong., 2d Sess., 136 CONG. REC. H928 (daily ed. Mar. 20, 1990), noting remarks by Rep. Dan Rostenkowski, former Chairman of the House Ways and Means Committee. Upon the introduction of The Foreign Tax Equity Act of 1990, Representative Rostenkowski observed that foreign-owned businesses in the United States pay very little federal income tax. *Id.* He referred to IRS data indicating that in 1986 foreign-owned businesses had gross income in excess of \$500 billion, but their tax liability was a negative one billion dollars. *Id.* Representative Rostenkowski stated the situation merited investigation as the U.S. tax laws imposed the same tax obligation on foreign-owned firms as on companies based in the United States. *Id.*

Former House of Representatives Majority Leader Richard Gephardt, Democrat from Missouri, upon the introduction of the Foreign Tax Equity Act of 1990, stated that foreign corporations that come to invest in the United States, and benefit from the quality of the American workers, the strength of the American transportation system and the wealth of American natural resources "ought to pay something in return. It's simple fairness." H.R. 4308, 101st Cong., 2d Sess., 136 CONG. REC. H929 (daily ed. Mar. 20, 1990). Representative Gephardt, on another occasion, said foreign-owned carmakers paid federal income tax equivalent to .00166% of United States assets. DAILY TAX REP. (BNA) Feb. 14, 1990, at G2. However, Representative Gephardt's dramatic statement suggesting significant underpayment of taxes by foreign carmakers is wrong because there is no presumption that a company, whether domestic or foreign, should pay its income taxes based upon a percentage of assets, irrespective of profits. All United States corporations pay taxes based upon their taxable income, not upon the level of sales or assets. I.R.C. § 11(a) (1994). Therefore, a company with a high volume of sales and a large amounts of assets is not automatically profitable.

House Ways and Means Oversight Subcommittee Chair James J. Pickle, Democrat from Texas, estimates that international transfer pricing costs the United States about \$30 billion each year, and that the cost to the U.S. Treasury over the next twenty years will be \$740 billion. Catherine Hubbard, *Transfer Pricing Robs States of Up to \$7 Billion Annually, Experts Say*, TAX NOTES, July 28, 1992, at 153. Representative Pickle's dramatic statement suggests that the cost of transfer pricing abuses exceeds the estimated total cost of the savings and loan bailout of the 1980s. *Id.* However, the contention of Representative Pickle is not even supported by the United States Treasury. The IRS Commissioner, Shirley Peterson, specifically discussed the \$30 billion annual estimate of uncollected taxes in her testimony before the House Ways and Means Committee. She stated that such an estimate could not be substantiated. *Hearings on H.R. 5270, supra* note 46, at 423.

54. WILLIAM CLINTON & AL GORE, PUTTING PEOPLE FIRST: HOW WE CAN ALL

ised that his Administration would collect an additional forty-four billion dollars in taxes from these companies through enhanced enforcement of the tax regulations.⁵⁵ In addition to the impact on the federal government, some estimate transfer pricing abuse to cost states an additional five billion dollars to seven billion dollars annually.⁵⁶

The IRS strategy of targeting foreign multinational firms to pay greater income taxes based upon perceptions of underpayment occurs at the expense of foresighted economic policy.⁵⁷ Thoughtful and wise economic policy serves to foster an economic environment that creates jobs and wealth for Americans, notwithstanding the nationality of the employer's shareholders.⁵⁸ When the IRS

CHANGE AMERICA 31 (1992).

55. *Id.*; see also Jeffrey H. Birnbaum, *Clinton's Revised Economic Plan Sets Massive Tax Increases for Foreign Firms*, WALL ST. J., June 22, 1992, at A16. In the president's 1993 State of the Union Message, President Clinton said his Administration would "seek to ensure that through effective tax enforcement foreign corporations who do make money in America simply pay the same taxes that American companies make on the same income." 29 Weekly Comp. Pres. Doc. 222-23 (Feb. 17, 1993).

56. HUBBARD, *supra* at note 53 at 153.

57. WEST'S FEDERAL TAXATION: CORPORATIONS, PARTNERSHIPS, ESTATES, AND TRUSTS 1-3 (William H. Hoffman, Jr. et al. eds., 1995). Hoffman states, "Using the tax system in an effort to accomplish economic objectives has become increasingly popular in recent years. Generally, this involves amending the Internal Revenue Code through tax legislation and emphasizes measures designed to help control the economy or encourage certain activities and businesses." *Id.*

Among the various examples of tax measures designed to encourage economic activities given by Hoffman, he asks:

Is it wise to stimulate U.S. exports of goods and services? Considering the pressing and continuing problem of a deficit in the U.S. balance of payments, the answer should be clear. Along this line, Congress has created foreign sales corporations (FSCs), a unique type of organization designed to encourage exports. A portion of the export income from eligible FSCs is exempt from Federal income taxes. Further, a domestic corporation is allowed a 100 percent dividends received deduction for distribution from an FSC out of earnings attributable to certain foreign trade income. Congress has also deemed it advisable to establish incentives for U.S. citizens who accept employment overseas. Such persons receive generous tax breaks through special treatment of their foreign-source income and certain housing costs.

Id. at 1-4.

58. REICH, *supra* note 18, at 110. Reich argues that the nationalities of companies or shareholders are irrelevant in setting national economic policies as "there is coming to be no such organization as an 'American' (or British or French or Japanese or West German) corporation, nor any finished good called an 'American' (or British, French, Japanese, or West German) product." *Id.* Rather, he asserts the focus of United States government policy should be to foster the development of the skills and abilities of the American people, which have now become our nation's primary assets. He notes:

[W]hen an 'American' company like General Motors shows healthy profits, this is good news for . . . its American investors. It is also good news for

aggressively targets foreign-owned multinational companies for audits, based upon perceptions of underpayment, it only serves to create a hostile economic environment.⁵⁹ A hostile economic environment does not advance the interests of the American public in the long term, because foreign multinational firms will simply transfer their investments to less hostile jurisdictions or limit the growth of investments in the United States.⁶⁰

Yet the pressures of large federal government deficits, combined with the minimal political risk of pursuing multinational

other GM executives worldwide and for GM's global employees, subcontractors, and investors. But it is not necessarily good news for a lot of routine assembly-line workers in Detroit . . . or anywhere else in America. Nor is it necessarily good news for the few Americans who are still working on assembly lines in the United States, who increasingly receive their paychecks from corporations based in Tokyo or Bonn. The point is that Americans are becoming part of an international labor market, encompassing Asia, Africa, Latin America, Western Europe, and increasingly, Eastern Europe and the Soviet Union. The competitiveness of Americans in this global market is coming to depend, not on the fortunes of any American corporation or on American industry, but on the functions Americans perform — the value they add — within the global economy.

Id. at 172.

59. See generally REICH, *supra* note 18, at 308. Reich notes: [Global] economic interdependence runs so deep, in fact, that any zero-sum strategy is likely to boomerang, as the members of the Organization of Petroleum Exporting Countries discovered in the 1970s when their sky-high oil prices plunged the world into recession and reduced the demand for oil. Today, no nation's central banker can control its money supply or the value of its currency without the help of other nations' central bankers, nor can a nation unilaterally raise its interest rates or run large budget surpluses or deficits without others' cooperation or acquiescence. These days, every advanced nation depends on others as a market for, and source of, its goods. The Japanese need a strong and prosperous America as a market for their goods and a place to invest their money. If any step they might take were to precipitate a steep economic decline in the United States, the results would be disastrous for the Japanese as well.

Id.

60. See generally *id.* at 3. Reich recognizes the process that presages the demise of national borders and national economies. He notes:

We are living through a transformation that will rearrange the politics and economics of the coming century. There will be no national products or technologies, no national corporations, no national industries. There will no longer be national economies. . . . All that will remain rooted within national borders are the people who comprise a nation. Each nation's primary assets will be its citizens' skills and insights. Each nation's primary political task will be to cope with the centrifugal forces of the global economy which tear at the ties binding citizens together—bestowing ever greater wealth on the most skilled and insightful, while consigning the less skilled to a declining standard of living. As borders become ever more meaningless in economic terms, [it is the most skilled and insightful] . . . citizens [who will be] best positioned to thrive in the world market.

Id.

corporations, ensure that the IRS will aggressively target both large and small multinationals for audits.⁶¹ These audits will involve all multinationals, whether they are based in the United States or abroad.⁶² The new IRS international tax regulations are intended to be more powerful weapons that the IRS will use to fight the perceived shifting of income by multinational corporations.⁶³

*C. International Transfer Pricing Is a Necessary Part of the
Business of Multinational Companies and the New Tax
Regulations Unfairly Impact Multinational Firms*

The most common accusation of income tax cheating leveled against multinational companies involves the use of international transfer pricing.⁶⁴ In an attempt to stanch the alleged losses resulting from international transfer pricing,⁶⁵ the IRS has imposed additional onerous reporting and record-keeping requirements and provided for severe penalties under the new § 482 regulations.⁶⁶ However, international transfer pricing is not a tax avoidance scheme.⁶⁷

A simple illustration of how intercompany transfer pricing works would be a Japanese corporation selling a television in the United States. Some of the profits resulting from the sale are earned in Japan; the remainder are earned in the United States. How should the company allocate the profit between the portion earned in Japan and that earned in the United States? Add to this example the fact that the Japanese television sold in the United States contains components or assemblies from the Japa-

61. Schwarz, *supra* note 52, at III. Schwarz writes, "Governments hard pressed for revenues are seeking transfer pricing as a possible revenue source. The attraction is that no tax increases need be legislated and the idea that foreign companies are not paying their fair share of taxes wins more votes than domestic tax increases." *Id.*

62. *Id.*

63. See generally Intercompany Transfer Pricing Regulations Under Section 482, 59 Fed. Reg. 34,971 (1994) (to be codified at 26 C.F.R. pt. 1 & 602).

64. Mackiewicz, *supra* note 52, at 357. Mackiewicz states, "The villain in all this [purported tax evasion] is international transfer pricing, a profit-shifting device used by both US and foreign-based companies." *Id.* She observes that "[President] Clinton's intention to collect an estimated \$30-45 billion annually in taxes from foreign-controlled companies doing business will prove very difficult to achieve. Tax enforcement against this obvious revenue source has been tried in the past and failed." *Id.*

65. See *id.*

66. See *infra* notes 86-146 and accompanying text for a discussion of the accounting methods and record-keeping requirements. See *infra* notes 147-61 and accompanying text for a description of penalty provisions for violations of these regulations.

67. Hearings on H.R. 5270, *supra* note 46, at 422.

nese company's affiliates in Thailand, South Korea, Singapore and Malaysia. The question of international transfer pricing deals with the distribution of profits among related companies located in various taxing jurisdictions.⁶⁸ Specifically, international companies use intercompany transfer pricing not as a tax avoidance scheme, but rather to price the transfer of goods, services, and intangible assets among related companies operating in different countries.⁶⁹ All multinational companies, domestic and foreign, must establish appropriate intercompany transfer prices for inter-

68. While the typical transfer pricing problem occurs in conjunction with manufactured products, it also is of concern for non-manufactured products. For example, suppose that a team of computer software designers and engineers from India, the United States, Italy and Brazil, each working in his or her own country, together develops a successful software product that is sold worldwide. How should the profits of that computer software project be taxed in the various jurisdictions?

Reich underscores the potential international tax problems in his description of interdependent trade. See REICH, *supra* note 18, at 111-13. He notes:

But in the emerging high-value economy, . . . [q]uantities [of products] can be produced efficiently in many different locations, to be combined in all sorts of ways to serve customer needs in many places. Intellectual and financial capital can come from anywhere, and be added instantly. Consider some examples: Precision ice hockey equipment is designed in Sweden, financed in Canada, and assembled in Cleveland and Denmark for distribution in North America and Europe, respectively, out of alloys whose molecular structure was researched and patented in Delaware and fabricated in Japan. An advertising campaign is conceived in Britain; film footage for it is shot in Canada, dubbed in Britain, and edited in New York. A sports car is financed in Japan, designed in Italy, and assembled in Indiana, Mexico, and France, using advanced electronic components invented in New Jersey and fabricated in Japan. A microprocessor is designed in California and financed in America and West Germany, containing dynamic random-access memories fabricated in South Korea. A jet airplane is designed in the state of Washington and in Japan, and assembled in Seattle, with tail cones from Canada, special tail sections from China and Italy, and engines from Britain. A space satellite designed in California, manufactured in France, and financed by Australians is launched from a rocket made in the Soviet Union.

Id. at 112.

69. DAVID K. EITEMAN & ARTHUR I. STONEHILL, *MULTINATIONAL BUSINESS FINANCE* 555 (5th ed. 1989). The issue of transfer pricing occurs in a wide range of circumstances, including: (1) the sale of raw materials to a related foreign party for use in either manufacturing or assembly; (2) the sale of finished goods to a related foreign party for resale to dealers or other distributors, independent manufacturers, or to ultimate consumers; (3) management and other services provided to related foreign parties (such as services in the areas of accounting and controllership, legal, management, advertising, marketing, invoicing, financial and bank loan negotiations, and other contract negotiations); (4) the leasing of tangible property, such as land, buildings, or other assets, by the owner to the related foreign party; (5) intercompany loans from one party to a related foreign party; and (6) rental or sale of intangible assets, such as patents, copyrights, licenses, or particular manufacturing technology owned by one company, but used by a related party. Richard L. Kaplan, *International Tax Enforcement and the Special Challenge of Transfer Pricing*, 1990 U. ILL. L. REV. 299, 300.

national transactions.⁷⁰

Income tax liability is a major consideration in setting the transfer price,⁷¹ but it is not the only or even the primary consideration.⁷² Rather, maximizing shareholder wealth is the fundamental goal in making business and financial decisions.⁷³ In order to maximize the value of its business, a multinational company must develop a "network of cash flows" that maximizes shareholder wealth.⁷⁴ In the absence of any tax regulations on international transfer pricing by the IRS, a multinational company maximizes its worldwide corporate profits by increasing profits in operations located in countries with low-tax rates and by lowering profits in operations located in countries with high-tax rates.⁷⁵

70. Although the intercompany transfer pricing problem exists for companies that operate solely in a domestic context but in more than one state, the use of transfer pricing in an international context becomes far more complicated. International firms must consider many variables in establishing the appropriate transfer price. These factors include managerial evaluation systems that monitor the performance of local management in various countries, foreign exchange risk, location and distribution of funds, tariffs and quotas, and effects on joint venture partners. EITEMAN & STONEHILL, *supra* note 45, at 558-60. The multinational corporation also must deal with added complications arising from political and cultural differences of operating in different countries, restrictions on imports and exports, and controls on the transfer of funds. Mohammed F. Al-Eryani et al., *Transfer Pricing Determinants of U.S. Multinationals*, 21 J. INT'L BUS. STUD. 409 (1990).

71. EITEMAN & STONEHILL, *supra* note 45, at 556.

72. Transfer pricing between decentralized profit centers can be a major determinant of managerial performance. EITEMAN & STONEHILL, *supra* note 45, at 558. Transfer pricing also has an influence on the amount of import duties paid, which is opposite to the income tax impact. As the transfer price paid by an affiliated importing company increases, the amount of ad valorem import taxes increase, though profits based upon transfer prices decrease. *Id.* at 559. The transfer pricing effect on joint ventures poses a particular problem for transfer pricing, because local stockholders would prefer to maximize local profits. *Id.* Other important factors in setting transfer pricing include the following: (1) internal foreign environment (competition and market conditions in the foreign country); (2) influences on cash flows (U.S. export incentives, exchange controls, floating exchange rates, and management of cash flows); (3) artificial barriers (customs duties, exchange controls, price controls, and import restrictions); (4) taxes (U.S. federal income taxes, other U.S. federal taxes, taxation in the foreign country); and (5) economic structures (U.S. export incentives and economic conditions in the foreign country). *Id.* at 560.

73. MADURA, *supra* note 26, at 4; JEFF MADURA & E. THEODORE VEIT, *INTRODUCTION TO FINANCIAL MANAGEMENT* 6 (1988).

74. MADURA, *supra* note 26, at 621.

75. EITEMAN & STONEHILL, *supra* note 45, at 556. For example, suppose that a multinational company (MNC) based in the United States operates a manufacturing plant in the United States and has a sales subsidiary in the imaginary no-tax jurisdiction of Freetaxia. MNC manufactures a product for \$5.00 per unit and sells it to non-related parties at \$15.00. Its taxable income would be based on the operating income of \$10.00 per product sold. Based upon a United States corporate tax rate of 34%, each product sold would result in a tax liability of \$3.40 (\$15.00 selling price for each unit less its \$5.00 cost, multiplied by the 34% U.S. corporate tax

However, the United States tax law is strict with regard to intercompany transfer pricing.⁷⁶ Section 482,⁷⁷ which governs intercompany transfer pricing allocations, requires that all transactions between affiliated parties be recorded as though they occurred at arm's length with an unaffiliated taxpayer.⁷⁸ On July 8, 1994, the IRS issued new regulations relating to intercompany transfer pricing under an arm's length standard.⁷⁹ The new regulations are part of the Clinton administration's "pledge" to "crack down on . . . the transfer pricing abuse."⁸⁰ These new regulations, while allowing a number of different transfer price accounting methods, add an exponential increase in paperwork, compliance costs and the need for additional professional experts in economics, accounting and the law in order for companies to justify their transfer prices.

rate). Therefore, the pre-tax operating income for MNC would be \$10.00, the tax payable would be \$3.40, and the after-tax operating income would be \$6.60.

However, assume MNC sells its products to its subsidiary in Freetaxia at \$7.00 each. The sales subsidiary then sells the product to its customers in Freetaxia (or elsewhere for that matter) at the regular price of \$15.00 each. The subsidiary's profit of \$8.00 per unit sold is not taxed in Freetaxia (Freetaxia is a no-tax jurisdiction). The sale of the product by MNC would be taxed by the IRS at 34% based on its profit of \$2.00 for each product sold, or a total tax liability of \$.68 (\$7.00 selling price less the \$5.00 cost of production multiplied by the 34% tax rate). Note that in this hypothetical example, the pre-tax operating income remains at \$10.00, but the total tax liability payable to the United States shrinks to \$.68, while the after-tax operating income increases from \$6.60 to \$9.32, an increase of 41%!

76. See Kaplan, *supra* note 69, at 304. Kaplan notes, "One could hardly ask for a more potent statutory weapon than section 482 of the Internal Revenue Code[.]" *Id.* "The U.S. laws in the [international transfer pricing] area are particularly strict[.]" MADURA, *supra* note 26, at 621.

77. I.R.C. § 482 (West 1995) reads as follows:

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.

Id.

78. Treas. Reg. § 1.482-1(b)(1) (1994).

79. See Intercompany Transfer Pricing Regulations Under Section 482, 59 Fed. Reg. 34,971 (1994) (to be codified at 26 C.F.R. pt. 1 & 602).

80. Rick Wartzman, *Foreign Firms' Income in U.S. is Understated*, WALL ST. J., June 4, 1993, at A2.

II. NEW IRS REGULATIONS ALLOW NUMEROUS TRANSFER PRICE ACCOUNTING OPTIONS FOR TAXPAYERS, YET CREATE ONEROUS DOCUMENTARY BURDENS, WITH INCREASED PENALTIES FOR PERCEIVED ABUSES

The United States Treasury spent years writing regulations in an attempt to improve application and enforcement of the transfer pricing rules in international transactions.⁸¹ The results, however, create even more problems for both taxpayers and the IRS. Every change in the law affecting international trade means added regulations, further tax rulings, more tax audits and ultimately more litigation, with a corresponding increase in the costs of preparing documentation to demonstrate compliance with the regulations.⁸² Initially, this section describes the accounting methods used to determine international transfer prices under the new IRS regulations and discusses the problems inherent in applying the regulations.⁸³ Next, this section reviews the documentation requirements of the new transfer pricing regulations and explains why they constitute an onerous burden on businesses.⁸⁴ Finally, this section considers how the elimination of the “reasonable cause and good faith” exception increases the likelihood of more litigation in the future.⁸⁵

A. IRS Regulations Allow Numerous Transfer Price Accounting Methods That Produce a Range of Appropriate Transfer Prices

The new IRS regulations for transfer pricing create taxpayer confusion.⁸⁶ The confusion arises because the regulations allow a number of different transfer price accounting methods that pro-

81. For an interesting and detailed account of the history of § 482, see Jerome R. Hellerstein, *Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment*, TAX NOTES INT'L, Aug. 24, 1993, at 163, available in LEXIS, Taxria Library, TNI file.

82. Kaplan notes, “A broadly drawn statute like section 482 merely sets the forum for the battles and does little to reduce their apparent intractability, enormous costs, and concomitant delays.” Kaplan, *supra* note 69, at 325.

83. See *infra* notes 86-115 and accompanying text for a discussion of the accounting methods used to determine an arm’s length transfer price.

84. See *infra* notes 116-46 and accompanying text for a discussion of the documentation requirements imposed on businesses to support their transfer pricing allocations.

85. See *infra* notes 147-61 and accompanying text for a description of how the elimination of the “reasonable cause and good faith” exception increases the likelihood of more litigation in the future.

86. See *supra* notes 86-115 and accompanying text for a discussion of why the variety of accounting methods allowed by the regulations create confusion in that they allow the taxpayer to determine a range of equally appropriate transfer prices.

duce a range of equally appropriate transfer prices.⁸⁷ This range of transfer prices creates a confusing array of taxable incomes.⁸⁸ As such, the IRS has created an international taxation system that compels taxpayers to pay an unknowable amount of tax.⁸⁹ Income taxes computed on transactions to related parties, therefore, are no longer rationally determinable, nor is the taxable income on such transactions determined consistently.

The IRS regulations specify that transactions with related parties must be placed on an equal basis with non-related parties.⁹⁰ The regulations provide six methods to establish such arm's length prices: (1) the comparable uncontrolled prices (CUP) method;⁹¹ (2) the resale price method;⁹² (3) the cost-plus method;⁹³ (4) the comparable profits method (CPM);⁹⁴ (5) the profit

87. *Id.*

88. See *supra* notes 86-115 and accompanying text for a discussion of how the variety of accounting methods permitted under the regulations allow the taxpayer to determine a range of taxable incomes.

89. This problem existed under prior § 482 regulations. Harlow N. Higinbotham et al., *Effective Application of the Section 482 Transfer Pricing Regulations*, 42 TAX. L. REV. 295, 330 (1987). Higinbotham notes, "For a potentially broad class of [tax] cases, application of any of the . . . [transfer pricing accounting] methods involves ambiguities in price determination that are often of the same order of magnitude as the taxable income to be allocated." *Id.*

90. See Treas. Reg. § 1.482-1(a)(1) (1994). The purpose of the regulations enforcing § 482 is to:

Ensure that taxpayers clearly reflect income attributable to controlled [party] transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled [party] taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled [party] taxpayer.

Id.

91. Treas. Reg. §§ 1.482-3(a)(1) (1994), 1.482-3(b)(1) (1994). A comparable uncontrolled price is regarded as the "most direct and reliable measure" of arm's length pricing. *Id.* §§ 1.482-3(b)(4), 1.482-3(b)(2)(ii)(A). This occurs when transactions in the same goods or services occur between the multinational firm and unrelated customers. EITEMAN & STONEHILL, *supra* note 45, at 558.

92. Treas. Reg. §§ 1.482-3(a)(2), 1.482-3(c)(1) (1994). The resale price method measures an arm's length price by subtracting an appropriate gross profit from the resale price of an affiliated distribution company. EITEMAN & STONEHILL, *supra* note 45, at 558.

93. Treas. Reg. §§ 1.482-3(a)(3), 1.482-3(d)(1) (1994). The cost-plus method measures the arm's length price by adding the gross profit to the cost of producing the goods or services involved in the transaction. *Id.* § 1.482-3(d)(2).

94. *Id.* §§ 1.482-3(a)(4), 1.482-5. Under the comparable profits method, the "arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable." *Id.* § 1.482-5(b)(1). The tested party refers to the participant "in the controlled transaction whose operating profit attributable to the controlled transaction can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located." *Id.* § 1.482-5(b)(2)(i). The profit level indicators represent "ratios that measure relationships between

split method;⁹⁵ and (6) unspecified methods.⁹⁶ However, the regulations, in determining the most appropriate accounting method a company should use for transfer pricing, do not prescribe a specific hierarchy of the methods.⁹⁷ Instead, the IRS requires that companies determine which of the accounting methods provides a subjective “most reliable” method.⁹⁸ But if the IRS decides that the transfer price chosen by a company is not the “most reliable,” then the IRS can select another accounting method to establish the “most reliable” price.⁹⁹

There is a major ambiguity in the practical application of these regulations. The IRS acknowledges that there can be a range of appropriate arm's length prices.¹⁰⁰ However, the IRS

profits and costs incurred or resources employed.” *Id.* § 1.482-5(b)(4). The IRS has acknowledged that a variety of profit level indicators can be computed in any particular case. *Id.* § 1.482-5(b)(4).

95. Treas. Reg. §§ 1.482-3(a)(5), 1.482-6. “The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss.” *Id.* § 1.482-6(a). For a description of the profit split method and its use for intangible assets, see Raymond F. Wacker, *Treasury's Proposed Regulations Allow Profit Split Method on Self-Developed Intangibles*, INT'L TAX J., Fall 1993, at 15.

96. Treas. Reg. §§ 1.482-3(a)(6), 1.482-3(1)(e) (1994). In addition to the methods described *supra* notes 91-95, other methods may be used to determine whether the amount charged was based on an arm's length price. Treas. Reg. § 1.482-3(1)(e)(1) provides that an unspecified method should be based upon the general principle that “uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it.” *Id.* § 1.482-3(1)(e)(1).

97. *See id.* § 1.482-1(c). The regulation states as follows:

The arm's length result of a controlled [party] transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used.

Id.

98. *Id.* § 1.482-1(c)(1). Under the temporary transfer pricing regulations, the applied standard in determining the transfer price accounting method was that it be the “most accurate.” Temp. Treas. Reg. § 1.482-1T(b)(iii)(A) (1993).

99. Treas. Reg. § 1.482-1(c) (1994). The regulation provides in pertinent part: An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

Id.

100. *Id.* § 1.482-1(e)(1). “In some cases, application of a pricing method will pro-

may allocate income based upon any one price within the range of possible transfer prices.¹⁰¹ Additionally, the regulations provide that when there are comparable, unrelated party transactions, the taxpayer's transfer price to related parties will meet the arm's length standard if and only if the transfer price falls within the range of prices for unrelated party transactions.¹⁰²

On the other hand, when there are no comparable transactions between related and unrelated parties, the regulations require that the taxpayer's transfer prices fall between the twenty-fifth percentile and seventy-fifth percentile of the selling prices to uncontrolled parties.¹⁰³ The IRS regulations refer to this range of transfer prices as the "interquartile range."¹⁰⁴ The regulations effectively allow the IRS to require the taxpayer's intercompany

duce a single result that is the most reliable measure of an arm's length result. In other cases, application of a pricing method may produce a number of results from which a range of reliable results may be derived." *Id.*

101. *See id.* § 1.482-1(e)(4). The regulations specifically state:

The rules . . . do not require that the [IRS] establish an arm's length range prior to making an allocation under section 482. Thus, for example, the [IRS] may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method . . . has been properly applied.

Id.

102. *See id.* § 1.482-1(e)(2)(ii). The regulation provides as follows:

Uncontrolled [party] comparable[] [transactions] must be selected based upon the comparability criteria relevant to the [transfer price accounting] method applied and must be sufficiently similar to the controlled [party] transaction that they provide a reliable measure of an arm's length result. . . . The arm's length range will be derived only from those uncontrolled [party] comparable[] [transactions] that have . . . a similar level of comparability and reliability, and uncontrolled [party] comparable[] [transactions] that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

Id.

103. *Id.* § 1.482-1(e)(2)(iii)(B) (1994). Under this regulation:

If there are no uncontrolled [party] comparable[] [transactions] . . . the arm's length range is derived from the results of all the uncontrolled [party] comparable[] [transactions] . . . that achieve a similar level of comparability and reliability . . . The reliability of the analysis is increased when . . . a range of results . . . [is] determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. [This] . . . range ordinarily provides an acceptable measure[.]

Id.

The regulation is absurd, for the IRS fails to explain how a taxpayer is to use the selling price for uncontrolled comparable transactions in order to determine the appropriate intercompany transfer price, when the uncontrolled comparable transactions do not exist.

104. *See id.* § 1.482-1(e)(3). The interquartile range requires that the taxpayer's price must fall within the 25th and 75th percentile of the non-related party transactions. *Id.*

transfer price to be at any point within the interquartile range.¹⁰⁵

The regulations also provide that the transfer price may be either at the median or even the arithmetic mean of all results.¹⁰⁶ Using either the arithmetic mean or median has significant limitations, as most applications require analysis of other statistical measures.¹⁰⁷ To compound problems, the regulations state that the median will “ordinarily”¹⁰⁸ be used, but the arithmetic mean will “normally”¹⁰⁹ be used. This gives the IRS great flexibility in selecting any transfer price it wishes.¹¹⁰

The regulations deal a final blow to a company’s judgment by stipulating that when uncontrolled party transactions have a significantly lower comparability to other transactions, they cannot be used to determine the appropriate transfer price.¹¹¹ This requires that all possible transactions be compared to each other. But if any transactions deviate widely from the other comparable

105. See *id.* § 1.482-1(e)(3).

106. *Id.* This regulations states:

If the results of a controlled [party] transaction fall outside the arm’s length range, the [IRS] may make allocations that adjust the controlled taxpayer’s result to any point within the arm’s length range. If the interquartile range is used to determine the arm’s length range, such adjustment will ordinarily be to the median of all the results. The median is the 50th percentile of the results. . . . In other cases, an adjustment normally will be made to the arithmetic mean of all the results.

Id.

107. The use of either the arithmetic mean or median to establish an appropriate transfer price provides an incomplete statistical analysis. “[I]t must be emphasized that there are very few practical situations where the complete information needed to solve a problem is presented by an average alone. In most applications, other statistical measures, such as measures of skewness and dispersion, are necessary.” BORIS PARL, BASIC STATISTICS 65 (1967).

108. See *supra* note 106 for an explanation of how an adjustment will ordinarily be made. In an array of ungrouped data, where numerical values are arranged in order of magnitude, the median is the middle value, so one half of the number of items will lie below the median, and one half above. Hence, the median reflects the positional average. For example, in the series of transfer price values of \$10, \$12, \$38, \$41 and \$44, the median transfer price value is \$38, as one half of the transfer prices (\$10 and \$12) lie below the median, and one half lie above (\$41 and \$44). See PARL, *supra* note 107, at 57.

109. See *supra* note 106 for an explanation of an adjustment “normally” made to the arithmetic mean of all the results. The arithmetic mean of a series of numbers is the sum of the numbers divided by the number of individual values. For example, the arithmetic mean of a series of transfer price values of \$10, \$12, \$38, \$41 and \$44 is: \$10 plus \$12 plus \$38 plus \$41 plus \$44 (divided by 5) = \$29. See PARL, *supra* note 107, at 51.

110. In the examples cited *supra* notes 108 and 109, the arithmetic mean of the range of transfer prices was \$29, the median was \$38. This difference between arithmetic mean and median shows how the IRS has the flexibility to select transfer prices practically at will to increase the taxable income of a company.

111. See Treas. Reg. § 1.482-1(e)(2)(iii)(B) (1994).

transactions, they cannot be used.¹¹² In the face of all this, it is the taxpayer who will have the burden of establishing to the IRS that the transfer price it selected on its tax return is correct.¹¹³

The new regulations are a conundrum. Paying the highest possible tax appears to be the only sure method to avoid transfer pricing problems with the IRS.¹¹⁴ Yet under the regulations, any tax paid may not be enough.¹¹⁵

B. Contemporaneous Documentation Requirements for Transfer Pricing Place an Onerous Burden on Multinational Companies

The new regulations impose a heavy documentary burden on companies that buy from or sell to related parties.¹¹⁶ American companies that manufacture and sell their products to affiliated entities throughout the world may easily require tens and even hundreds of thousands of pages of financial and economic analy-

112. *Id.* § 1.482-1(e)(2)(ii). According to the regulation, “[t]he arm’s length range will be derived only from those uncontrolled [party] comparable[] [transactions] . . . that have . . . a similar level of comparability and reliability, and uncontrolled [party] comparable[] [transactions] that have a significantly lower level of comparability and reliability will not be used in establishing the arm’s length range.” *Id.*

113. *Id.* § 1.482-1(e)(4). Under the regulation, “[i]f the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices[,] . . . then no allocation will be made.” *Id.*

114. One commentator notes that “[t]he vast proliferation of rules in the law of federal taxation rests upon the belief that elaborate rules can render tax law both fair and certain.” John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 3 (1993). He then shows that the effort to attain both fairness and certainty through vast elaboration of tax rules “is inherently contradictory and yields a never ending spiral of complexity. . . . [Further,] elaborative complexity contributes to the practical indeterminacy of tax law by rendering the law beyond the ken of those persons who are supposed to apply it.” *Id.* at 5.

115. *See id.* at 12. Miller asks:

When should a transaction be taxed according to its substance rather than its form? When should several transactions occurring in sequence be taxed according to their end result? Is a certain transaction a realization event? What is the true economic nature of a certain transaction? These are but a sampling of the judgmentally complex questions that may be posed by quite ordinary economic events. Most often judgment complexity arises because more than one rule or principle may apply to a given taxable event, and those potentially applicable principles are in conflict. Resolving the conflict calls for a fine sense of judgment even of one who well understands all of the potentially applicable rules. Just as elaborative complexity correlates with practical indeterminacy, judgmental complexity correlates with theoretical indeterminacy. The more judgmentally complex a [tax] question is, the more theoretically indeterminate is its answer.

Id. at 12-13.

116. *See supra* notes 116-46 and accompanying text for a discussion of how the new regulations impose a heavy documentary burden on companies for their related party transactions.

ses in order to justify their international transfer prices.¹¹⁷ Moreover, the imposition of the new § 482 documentation requirements provides the IRS with a great deal of evidence that the IRS can use to buttress its own conclusions.¹¹⁸

The multinational taxpayer now must prepare nine types of documents prior to filing a United States tax return.¹¹⁹ The documentation must exist when the taxpayer files its return,¹²⁰ and the taxpayer must provide these documents to the IRS within

117. The economic and financial analyses necessary to show the income results for transfer pricing accounting methods not selected would require that a firm prepare at least five additional economic and financial analyses for each product or service produced at each of its manufacturing locations, based upon the transfer pricing accounting methods described *supra* notes 91-96. An international manufacturer may choose to manufacture its products in multiple locations. Companies tend to do this for several reasons. First, it enables the manufacturer to interact more closely with customers by placing manufacturing facilities in closer proximity to major customers. This allows manufacturers to respond more easily to customer requests and eliminates many of the problems associated with long distance communication between customers and manufacturers. Second, manufacturing products in multiple locations serves to minimize risks of political upheaval, strikes, and similar developments. Third, distributing production among multiple locations reduces the risk of production shutdowns and delivery delays to customers from fire and other natural disasters. This enables the manufacturer to continue to meet its customers needs despite the destruction or shutdown of one of the manufacturing plants.

For example, a major international manufacturing company, such as General Electric, which manufactures more than 500,000 different products, many of which are manufactured in multiple locations, could prepare up to several million pages of economic analyses to establish the range of transfer price for its products.

118. See *infra* notes 130-43 and accompanying text for a discussion of how the IRS was able to prevail in a transfer pricing case by using the taxpayer's internal documentation.

119. Temp. Treas. Reg. § 1.6662-6T(d)(2)(iii)(B)(1)-(9) (1994). Among the documents required to be in existence at the time the tax return is filed are the following:

- (1) [a]n overview of the taxpayer's business, including an analysis of the economic and legal factors that affect the pricing of its property or services;
- (2) [a] description of the taxpayer's organizational structure . . . covering all related parties . . . including foreign affiliates whose transactions directly or indirectly affect the pricing of property in the United States;
- (3) [a]ny documentation explicitly required by the regulations under section 482;
- (4) [a] description of the [transfer pricing] method selected and an explanation of why that method was selected;
- (5) [a] description of the alternative methods that were considered, and an explanation of why they were not selected;
- (6) [a] description of the controlled transactions . . . and internal data used to analyze those transactions . . . ;
- (7) [a] description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made;
- (8) [a]n explanation of the economic analysis and projections relied upon in developing the [transfer pricing] method.

Id.

120. *Id.*

thirty days of a request.¹²¹ The taxpayer must explain both why the company selected a specific transfer pricing accounting method¹²² and why the company did not select the other methods.¹²³ All of the company's internal data and analyses of transactions between related parties and non-related parties must be available to the IRS.¹²⁴ The IRS determines whether the taxpayer's conclusions are reasonable from all of the facts and circumstances.¹²⁵

By the use of such contemporaneous documentation, the IRS can corroborate any reallocation of income based upon changes in transfer pricing. After all, if the taxpayer's internal company documents can support the use of a particular transfer price, then the same documents can support the IRS's selection of that price.¹²⁶ The taxpayer will be hard pressed to claim that the IRS selected an arbitrary or capricious transfer price when that price previously has been determined to be within a relevant range by the taxpayer itself.¹²⁷ This regulation effectively forces compa-

121. *Id.* § 1.6662-6T(d)(2)(iii)(A).

122. *Id.* § 1.6662-6T(d)(2)(iii)(B)(4).

123. *Id.* § 1.6662-6T(d)(2)(iii)(B)(5).

124. *Id.* § 1.6662-6T(d)(2)(iii)(A). This regulation states, "The documentation requirement is met if the taxpayer maintains sufficient documentation to establish . . . the [accounting] method . . . [that] provides the most accurate measure of an arm's length result[,] . . . and provides that documentation to the [IRS] within 30 days of a request for it." *Id.*

125. According to Temporary Treasury Regulation § 1.6662-6T(d)(2)(ii)(A)-(E), in order to determine whether the intercompany transfer price is reasonable, the IRS will examine several factors:

(A)[t]he experience and knowledge of the taxpayer . . . ; (B) [t]he extent to which accurate [transfer pricing] data was available and [whether] the data was analyzed in a reasonable manner; (C) [t]he extent to which the taxpayer reasonably relied upon the analysis of, or a study done by, a professional qualified to conduct such an analysis or study, including an attorney, accountant, or economist. Whether the professional is an employee of or related to, the taxpayer is not determinative . . . as long as the analysis is objective, thorough, and well-reasoned.

Id.

126. *Id.* § 1.6662-6T(d)(2)(ii). This regulation provides in pertinent part:

The taxpayer's selection and application of a specified [accounting] method is reasonable only if . . . the taxpayer reasonably concluded that the [accounting] method . . . provided the most reliable measure of an arm's length result[,] . . . A taxpayer can reasonably conclude that a specified [accounting] method provided the most reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the other specified [accounting] methods[.]

Id.

127. Treas. Reg. § 1.482-1(e)(3) (1994). The IRS may allocate a transfer price anywhere within the arm's length range. "If the results of a [related party] transaction fall outside the arm's length range, the [IRS] may . . . allocat[e] . . . taxpayer's result to any point within the arm's length range." *Id.* However, the regulations do not require the IRS to establish an arm's length range as a prereq-

nies to provide the IRS sufficient information to allow the IRS to justify any reallocation of income based upon changes in transfer pricing.¹²⁸

The last great IRS transfer price victory stemmed from such internal information and memoranda provided by a taxpayer to the IRS.¹²⁹ One commentator has even suggested that judicial deference to the IRS's transfer pricing allocation of income reached its zenith in *E. I. Du Pont De Nemours & Co. v. United States*.¹³⁰ Du Pont, the giant American chemical company, created a wholly-owned Swiss marketing and sales subsidiary for its foreign sales.¹³¹ Most of Du Pont's chemical products marketed abroad were first sold to the Swiss subsidiary, which then arranged for resale to the ultimate consumer through independent distributors.¹³² The IRS reallocated profits to the United States taxpayer pursuant to § 482, finding that the split in profit between the American manufacturer and the Swiss subsidiary was economically unrealistic.¹³³ The IRS's reallocation substantially increased Du Pont's taxes.¹³⁴

Although the court believed that the Swiss subsidiary was not a "sham entity,"¹³⁵ in that it served substantial commercial functions, the court did find that "it [was] also undeniable that the tax advantages of such a foreign entity were . . . an important,

uisite to allocation. *Id.* § 1.482-1(e)(4). The regulation states that "[t]he [transfer pricing regulations] . . . do not require that the [IRS] establish an arm's length range prior to making an allocation under § 482. Thus, for example, the [IRS] may properly propose an allocation on the basis of a single comparable [non-related party transfer] price[.]" *Id.*

128. See *supra* notes 119-25 and accompanying text for a discussion of how this regulation effectively forces companies to provide the IRS such information.

129. See *infra* notes 130-43 and accompanying text for a discussion of how the IRS was able to prevail in a transfer pricing case by using the taxpayer's internal documentation.

130. 608 F.2d 445 (Ct. Cl. 1979), *cert. denied*, 445 U.S. 962 (1980); Francis M. Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX REV. 423, 487 (1994).

131. *Du Pont*, 608 F.2d at 446.

132. *Id.*

133. *Id.*

134. *Id.* Kaplan notes:

Needless to say, the government was able to defeat handily Du Pont's efforts to justify its prices after the fact . . . and won a reallocation of some \$18 million for the two taxable years (1959 and 1960) in question. The interesting point from the perspective of enforcement and compliance is that no penalties were imposed beyond the usual statutory interest — so, who got the last laugh? Du Pont had the use of its \$18 million for nearly twenty years and ended up paying on the tax due plus accumulated interest. Not a small price, to be sure, but no real downside risk to counter the attitude of the memorandum, either.

See Kaplan, *supra* note 69, at 307.

135. *Id.* at 447.

though not the primary, consideration in [the] creation and operation [of the subsidiary.]”¹³⁶ The court’s finding was based upon Du Pont’s internal memoranda, which were replete with references to tax advantages used to plan the selling price of Du Pont’s products to the new subsidiary.¹³⁷ The court concluded that Du Pont’s prices on sales to the Swiss subsidiary were calculated to

136. *Du Pont*, 608 F.2d at 447.

137. *Id.* The court explained that the tax strategy was simple. *Id.* Du Pont was to sell goods to the Swiss subsidiary below fair market value. *Id.* The Swiss subsidiary would then earn higher profits. *Id.* Because the Swiss subsidiary would pay income taxes based upon a Swiss corporate tax rate “at a much lower level,” Du Pont as a whole would minimize its taxes and increase its aftertax profits. *Id.* The Swiss subsidiary’s large profits would then finance Du Pont capital improvements in Europe. *Id.*

The court noted that early memoranda to the Executive Committee of Du Pont from its International Department stated that the Treasury Department, Du Pont’s internal department responsible for tax planning, was considering the possibility of a “transfer of goods to a tax haven subsidiary at prices less than such transfers would be made to other subsidiaries or industrial Departments[.]” *Id.* at 447 n.4. The same department reviewed the likelihood of an IRS attack on such transfer pricing and concluded:

It would seem to be desirable to bill the tax haven subsidiary at less than an ‘arm’s length’ price because: (1) the pricing might not be challenged by the revenue agent; (2) if the pricing is challenged, we might sustain such transfer prices[;] (3) if we cannot sustain the prices used, a transfer price will be negotiated which should not be more than an ‘arm’s length’ price and might well be less; thus we would be no worse off than we would have been had we billed at the higher price.

Id.

The court then cited a subsequent department report on “Use of a Profit Sanctuary Company by the Du Pont Company,” which advised pricing goods to the “profit sanctuary” at considerably lower levels than other intercorporate sales, suggesting that such prices could probably be sustained against an IRS challenge. *Id.* A later memorandum by Du Pont’s International Department stated that the principal advantage of a “profit sanctuary trading company” (identified as a “PST company”) depended “largely upon the amount of profits which might be shifted (through selling price) from Du Pont to the ‘PST company’” *Id.* The memorandum concluded that Du Pont could find “a selling price sufficiently low as to result in the transfer of a substantial part of the profits on export sales to the ‘PST company.’” *Id.* Later, a Du Pont task force selected Switzerland as the best location for the foreign trading subsidiary, primarily because of the Swiss tax considerations. *Id.*

Although the two principal Du Pont manufacturing divisions that were to be the main suppliers to the Swiss company were not enthusiastic about its creation, viewing it as establishing a new and additional layer of company organization, they did ultimately agree based upon the tax reasons. *Id.* One of the divisions concluded, “The decisive factor in our support of the [Swiss company’s] organization is the potential tax savings.” *Id.* The other division recognized that tax considerations “will command the establishment of lowest practical transfer prices from the manufacturing subsidiaries to Du Pont Swiss [subsidiary.]” *Id.*

The court also noted a memorandum to Du Pont’s Executive Committee spoke of the modest markup of goods sold to the foreign trading subsidiary. *Id.* An earlier draft of the memorandum used the phrase “artificially low price[s].” *Id.*

give substantial profits to that subsidiary.¹³⁸ In fact, the court stated, “[T]he pricing system was based solely on [Du Pont’s] Treasury and Legal Department estimates of the greatest amount of profits that would be shifted to [the Swiss subsidiary] without evoking IRS intervention.”¹³⁹

Du Pont sought to justify the pricing as being similar to other sales to non-related parties,¹⁴⁰ but the accounting methods used by the IRS in countering Du Pont were not subject to close scrutiny. Indeed, the Court of Claims stressed that only the IRS’s results would be subject to the court’s review, not its accounting methods.¹⁴¹ While the court was correct in concluding that Du Pont engaged in tax avoidance by shifting income to its Swiss subsidiary the rationale used to justify the IRS’s reallocation of income was overbroad. The court allowed the IRS to reallocate intercompany transfer prices on an arbitrary basis as long as the IRS reached a result “within the zone of reasonableness.”¹⁴² The result was reasonable, so the IRS’s allocation was acceptable.¹⁴³

The IRS prevailed principally because the internal memoranda suggested that Du Pont’s intention was to avoid taxes.¹⁴⁴ Imposition of the new § 482 documentation requirements will provide the IRS with even more ammunition. The same internal company documents used by a taxpayer to consider and reject an

138. *Id.* at 448.

139. *Id.* The court referred to the testimony of a key Du Pont Treasury Department official, who conceded he would have set prices to the Swiss subsidiary so as to shift 99% of the total profits to the subsidiary if he thought the allocation would survive IRS scrutiny. *Id.*

140. Du Pont attempted to apply the resale price method. *Id.* at 450. By comparing the average markup percentage of 21 unrelated distribution companies whose business activities were comparable to those of the Swiss subsidiary, Du Pont sought to demonstrate that the Swiss subsidiary’s average annual markup percentage was comparable to the group average. *Id.* Therefore, Du Pont concluded, the prices charged to its Swiss subsidiary company were reasonable. *Id.* at 451. The purportedly comparable distribution companies, however, sold electronic and photographic equipment, and functioned primarily in the United States. *Id.* at 452.

141. The court stated, “In reviewing the [IRS’s] allocation of income under Section 482, we focus on the reasonableness of the result, not the detail of the examining agent’s methodology . . . consider[ing] the reasonableness of the [IRS’s] result under its very broad delegation.” *Id.* at 454-55.

The court concluded, “The amount of reallocation would not be easy for us to calculate if we were called upon to do it ourselves, but Section 482 gives that power to the [IRS] and we are content that [the] amount . . . was within the zone of reasonableness.” *Id.* at 455.

142. *Id.*

143. *Id.* at 456. Amazingly, the court remarked that the derivation of “realistic intercompany prices is hardly . . . an economic art susceptible of precision,” and that “[a]’broad brush’ approach to this inexact field seems necessary[.]” *Id.* at 455.

144. See *supra* notes 130-43 and accompanying text for a demonstration of the Tax Court’s reliance upon Du Pont’s memoranda and other documentation to transfer profits to the foreign subsidiary.

allowable transfer price can be used by the IRS to impose that price.¹⁴⁵ As discussed above, the accounting methods in themselves provide an array of transfer prices that can be used by the IRS;¹⁴⁶ the requirement of contemporaneous documentation augments the IRS arsenal.

*C. The Exception for Transfer Price Penalties Based on
"Reasonable Cause and Good Faith" Was Wrongly Eliminated*

In conjunction with the issuance of new § 482 regulations, the IRS issued temporary regulations governing the imposition of transfer pricing adjustment penalties.¹⁴⁷ Penalties for failing to maintain adequate documentation are significant. The IRS may impose a twenty percent penalty under certain conditions,¹⁴⁸ and a forty percent penalty for more egregious transfer pricing violations.¹⁴⁹ However, the Omnibus Budget Reconciliation Act of 1993 eliminated the exception to the severe transfer pricing penalties that previously was afforded to a taxpayer that showed "reasonable cause and good faith" in establishing its transfer prices.¹⁵⁰

The statutory exception to transfer pricing penalties now

145. See *supra* notes 116-46 and accompanying text for a discussion on how an allowable transfer price can be used by the IRS to impose that price.

146. See *supra* Part II.A.

147. Imposition of Accuracy-Related Penalty, 59 Fed. Reg. 35,030 at 35,031 (1994) (to be codified at 26 C.F.R. pt. 1 & 602).

148. The IRS can impose a 20% penalty if the net transfer pricing adjustments exceed the lesser of \$5 million or 10% of the gross receipts. Treas. Reg. § 1.6662(e)(1)(B)(ii) (1994). In addition, the IRS can impose a 20% penalty if the actual transfer price is 200% or more, or 50% or less, of the corrected amount. *Id.* § 1.6662(e)(1)(B)(i). Thus, if GigantaCorp. sells a \$10 product to a related party, it would be subject to a 20% penalty if the "correct" transfer price was \$20 or more, or \$5 or less.

149. Penalties increase to 40% when the net transfer pricing adjustments exceed \$20 million, Treas. Reg. § 1.6662(h)(2)(A)(iii)(I) (1994), or when the transfer pricing adjustments constitute 20% of gross receipts. *Id.* § 1.6662(h)(2)(A)(iii)(II).

The IRS can also impose 40% penalties when the actual transfer price is 400% or more of the corrected amount, Treas. Reg. § 1.6662(h)(2)(B) (1994), or when the actual transfer price is 25% or less of the corrected amount. *Id.* § 1.6662(h)(2)(A)(ii). Thus, if Giganta Corp. sells a \$10 product to a related party, it would be subject to a 40% penalty if the "correct" price was \$40 or more, or \$2.50 or less.

150. Section 13236 of the Omnibus Budget Reconciliation Act of 1993, Pub L. 103-66, 107 Stat. 312, amended Sections 6662(e) and (h) of the Internal Revenue Code.

The statute that establishes the \$5 million and \$20 million thresholds excludes from those thresholds adjustments "attributable to any redetermination of a price if it is established that the taxpayer determined such price in accordance with a specific pricing method set forth in the [§ 482] regulations and that the taxpayer's use of such method was reasonable." Treas. Reg. § 1.6662(e)(3)(B)(a)(I) (1994).

requires that the taxpayer reasonably believed and correctly selected the transfer price accounting method that produced the most reliable measure of the transfer price on an arm's length basis.¹⁵¹ Given that the standard for reasonableness is now whatever the IRS determines to be a "more reliable"¹⁵² measure within the range of allowable prices,¹⁵³ the possibility of significant penalties forms a potentially powerful negotiating position for the IRS in its audit with a multinational taxpayer. Elimination of the "reasonable cause and good faith" exception strips the taxpayer of a vital defense.

The IRS warns, "If the taxpayer attempt[s] to determine an

151. Temp. Treas. Reg. § 1.6662-6T(d)(2)(ii) (1994). This regulation states in pertinent part:

The taxpayer's selection and application of a specified [transfer price accounting] method is reasonable only if, given the available data and the applicable [transfer] pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result. . . . A taxpayer can reasonably conclude that a specified [transfer pricing accounting] method provided the most reliable measure of an arm's length result only if it has made a reasonable effort to evaluate the potential applicability of the other specified methods[.]

Id.

152. Treas. Reg. § 1.482-1(c)(1). The regulation provides in pertinent part:

The arm's length result of a controlled [party] transaction must be determined under the [accounting] method that . . . provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any [accounting] method without establishing the inapplicability of another [accounting] method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used.

Id.

153. See *supra* notes 97-100 and accompanying text for a discussion of the range of allowable transfer prices without a hierarchy for application. The IRS regulations state that the determination of the reasonableness of the taxpayer's conclusions is based upon "all of the facts and circumstances[.]" Temp. Treas. Reg. § 1.6662-6T(d)(2)(ii) (1994). But the test for reasonableness is based upon a number of factors. These include, first, use of the accounting methods prescribed in the § 482 regulations. *Id.* § 1.6662-6T(d)(2)(ii)(C). The supporting transfer pricing documentation also must consider and evaluate the applicability of each of the other accounting methods. "The documentation requirement . . . is met if the taxpayer maintains sufficient documentation to establish that the taxpayer reasonably concluded that, given the available data and the applicable [transfer] pricing methods, the method (and its application of that method) provided the most accurate measure of the arm's length result[.]" *Id.* § 1.6662-6T(d)(2)(iii)(A). In addition, reasonableness is established by the existence of appropriate documentation to establish that the taxpayer reasonably concluded the transfer pricing method selected provided the "most accurate measure of an arm's length result[.]" *Id.* § 1.6662-6T(d)(2)(iii)(A). Finally, the supporting documentation must be existence when the tax return is filed, and it must be provided to the IRS within 30 days of request for it. *Id.*

arm's length result by . . . arbitrarily select[ing] a result that corresponds to an extreme point in the range of [transfer price] results . . . [s]uch a result generally would not likely be closest to an arm's length result."¹⁵⁴ The new regulations provide that selecting a median point in the allowable range would be one reasonable method of selecting an appropriate price.¹⁵⁵ Thus, taxpayers with transfer pricing deficiencies potentially have a greater risk of penalty than they did before, even if they do not meet the percentage test and the total level of transfer price adjustments are not large enough.¹⁵⁶ Previously, in order to avoid a twenty percent underpayment penalty, the taxpayer needed to have a nonfrivolous disclosed position or to have been able to show reasonable cause and good faith.¹⁵⁷ Now the reasonable cause exception does not apply unless the taxpayer established the transfer price at the median of a range of possible transfer prices.¹⁵⁸ The latter showing would relieve the taxpayer from a negligence penalty.¹⁵⁹

Therefore, while the regulations recognize that problems may occur in establishing transfer prices within an appropriate range,¹⁶⁰ the only way a taxpayer likely could avoid the enhanced transfer pricing penalties is by showing that it did not select a transfer price the IRS would consider arbitrary, or one the IRS would consider to be at an extreme point in the transfer

154. *Id.* § 1.6662-6T(d)(2)(ii)(E).

155. *Id.* This section states, "One reasonable method of selecting a point in the range would be that provided in § 1.482-1(e)(3)." *Id.* Section 1.482-1(e)(3) provides that "[i]f the results . . . fall outside the arm's length range, the [IRS] may . . . allocat[e] the taxpayer's result to any point within the arm's length range[.] . . . such adjustment will ordinarily be to the median of all the results. The median is the 50th percentile of the results[.]" Treas. Reg. § 1.482-1(e)(3) (1994).

156. Burgess J. W. Raby & William L. Raby, *Rabys Find Section 482 Penalty Regs are Largely Legitimized by OBRA '93*, TAX NOTES INT'L, Aug. 27, 1993, available in LEXIS Taxria Library, TNI file.

157. *Id.*

158. Treas. Reg. § 1.6662(e)(3)(D) (1994). This regulation states:

For purposes of section 6664(c) [imposing no penalty to any portion of a tax underpayment if it is shown that there was a reasonable cause and that the taxpayer acted in good faith,] the taxpayer shall not be treated as having reasonable cause for any portion of an underpayment attributable to a net section 482 transfer price adjustment unless such taxpayer meets the requirements of clause (i) [wherein taxpayer determines the transfer price in accordance with a specific transfer pricing method in the section 482 regulations, and], [clause] (ii) [wherein taxpayer determines the transfer price in accordance with unspecified methods, that nonetheless result in a transfer price that clearly reflects income.]

Id.

159. *Id.*

160. See *supra* notes 100-13 and accompanying text for a discussion of such recognition.

price range.¹⁶¹

III. RESULTS OF RECENT INTERNATIONAL TRANSFER PRICING CASES CORRECTLY LIMIT IRS, BUT THE NEW REGULATIONS WILL LIKELY EXACERBATE PROBLEMS LITIGATED UNDER PRIOR REGULATIONS

The IRS has a poor track record in the litigation of international transfer pricing cases.¹⁶² Some commentators have suggested that the IRS has not won a substantial international transfer pricing case since 1979.¹⁶³ Remarkably, the Tax Court has regularly rejected the IRS's § 482 allocations in major cases, either entirely or in large part,¹⁶⁴ despite the deference granted to the IRS for those allocations.¹⁶⁵ In typical litigation, the burden of proof rests with the plaintiff,¹⁶⁶ but in tax litigation, the taxpayer generally has the burden of proof.¹⁶⁷

161. Temp. Treas. Reg. § 1.6662-6T(d)(2)(E) (1994).

162. For an interesting article on why the IRS loses far more than it wins in cases with more than \$10 million at issue, see George Gutman, *IRS Averages: Winning Little, Losing Big*, TAX NOTES, Oct. 14, 1993, available in LEXIS, Taxria Library, TNT File. Gutman notes that, according to IRS statistics for the first 11 months of fiscal 1993, the IRS recovered about \$.17 on the dollar in cases with over \$10 million at issue. *Id.* However, for the 87 cases settled without trial, the IRS received approximately \$.12 on the dollar. *Id.* At the same time, of the 30,263 cases settled with under \$10 million at issue, the IRS got about \$.42 on the dollar. *Id.*

163. Allegra, *supra* note 130, at 433 n.25. Allegra notes, "The last major victory for the [IRS] in a transfer pricing case was the 1979 Court of Claims decision in *E.I. Du Pont de Nemours & Co. v. United States*["] *Id.*

164. *Id.* at 433. Allegra notes, "Indeed, during the last decade or so the courts have rejected, in whole or in large part, the [IRS's] section 482 determinations in each of the major cases decided." *Id.*

165. *Id.* at 434. Allegra notes:

Before the most recent onslaught of government [transfer pricing tax allocation] defeats, Congress criticized the [tax] courts for applying an incorrect standard of judicial review in section 482 cases, one affording 'little deference to the [IRS] and permitting the [tax] court to effectively substitute its own judgment for that of the [IRS].' Characterizing such comments as 'rather troubling,' the former Chief Judge of the Tax Court responded by stating: I wish to assure Congress and all others that the Tax Court has no intention of routinely substituting its judgment for that of the tax administrator. Nevertheless, many of the cases we've been talking about involve hundreds of millions of dollars, sometimes determined by the [IRS] in the most generalized way, and in a free society such as ours, it is essential that review by an independent tribunal like the Tax Court be available. And nothing must be done to undermine that independence.

Id.

166. Leo P. Martinez, *Tax Collection and Populist Rhetoric: Shifting the Burden of Proof in Tax Cases*, 39 HASTINGS L.J. 239, 250 (1988). Typically in litigation, the allocation of the burden of proof provides that the party having the affirmative side of an issue also is assigned the burden of proof. *Id.*

167. *Id.* at 257 n.82 (citing a number of cases where Courts have shifted the burden of proof to the IRS).

The Supreme Court has acknowledged the difficulty in allocating profits among related companies. Even as far back as 1920, in the case *Underwood Typewriter Co. v. Chamberlain*,¹⁶⁸ Justice Brandeis "[recognized] the impossibility of allocating specifically the profits earned" by a business that conducts "a series of transactions beginning with manufacture in [one state], and ending with sale in other States."¹⁶⁹ It is inherently difficult because "all the factors in [such an] enterprise are essential to the realization of profits."¹⁷⁰ Although litigation of recent international transfer pricing cases began under prior transfer pricing regulations, the writers of the most recent regulations have sought to minimize those factors which courts have found unpersuasive.

This Part examines the results in four recent international transfer pricing cases. Section A discusses an IRS allocation that was arbitrary and capricious because the IRS did not follow its own prescribed accounting methods to determine the transfer pricing adjustments.¹⁷¹ Section B demonstrates that an IRS determination of transfer prices was unreasonable because the IRS's economic analysis bore no relationship to the IRS's notice of deficiency.¹⁷² Section C discusses the Tax Court's rejection of an extreme position taken by the IRS.¹⁷³ Section D reviews the failure

However, despite some attempts by courts to shift the burden of proof to the IRS, the issue of placing the burden of proof on the taxpayer is well-settled. Martinez, *supra* note 166, at 260 n.98. However, Martinez identifies a number of situations in which the IRS does have the burden of proof on certain issues in the Tax Court and in suits to recover refunds from the IRS. These include cases involving fraud, wrongdoing by foundation managers, affirmative defenses and counterclaims, transferee liability, and Accumulated Earnings Tax. *Id.* at 263-66. Martinez writes that the most important problem arising from shifting the burden of proof to the IRS is a practical one: the IRS is unable to sustain the burden of proof because it does not possess the evidence. *Id.* at 277.

168. 254 U.S. 113 (1920).

169. *Id.* at 120-21.

170. *Butler Bros. v. McCollgan*, 315 U.S. 501, 508 (1942).

171. See *infra* Part III.A for a discussion of *Seagate Technology v. Commissioner*, 102 T.C. 79 (1994), in which the taxpayer proved that the IRS's allocation was arbitrary and capricious because the IRS did not follow its own prescribed accounting methods to determine the international transfer pricing adjustments.

172. See *infra* Part III.B for a discussion of *National Semiconductor v. Commissioner*, 67 T.C.M. (CCH) 2849 (1994), in which the Tax Court found that the IRS determination of transfer prices charged between the manufacturer of semiconductor products and its international subsidiaries was unreasonable because the IRS's economic analysis bore no relationship to the IRS's notice of deficiency.

173. See *infra* Part III.C for a discussion of *Exxon v. Commissioner*, 66 T.C.M. (CCH) 1707 (1993), in which the Tax Court rejected the extreme position taken by the IRS in claiming that Exxon and Texaco owed over eight billion dollars in additional taxes from selling Saudi crude oil below market prices to their overseas refining subsidiaries. The sales in question occurred when the government of Saudi Arabia, with the approval of the United States government, dictated the oil prices,

of the IRS to establish a sound transfer price accounting method.¹⁷⁴ The issues litigated under prior regulations that were involved in these cases have not been resolved in the new § 482 regulations. On the contrary, by failing to establish a rational hierarchy of accounting methods and by increasing the threat of stiff penalties, the new regulations are likely to exacerbate problems for both the taxpayers and the IRS.

A. The IRS Fails to Follow Appropriate Accounting Methods to Determine International Transfer Pricing Adjustments in Seagate Technology, Inc. v. Commissioner

In *Seagate Technology, Inc. v. Commissioner*,¹⁷⁵ the taxpayer challenged the IRS's proposed transfer pricing adjustments between the parent company and its Singaporean subsidiary. The Tax Court rejected most of the IRS's proposed allocations of income and expenses because the IRS allocations were inconsistent with the very methods that the IRS had argued should be followed.¹⁷⁶ The Tax Court also disapproved the IRS's transfer pricing allocation because the IRS made serious computational errors by using incorrect sales revenues and excessively high gross profit percentages to determine what the taxpayer's transfer prices should have been.¹⁷⁷ Consequently, Seagate was able to demonstrate that the IRS's transfer pricing adjustments for the taxpayer's electronic components were arbitrary and excessive.¹⁷⁸ Still, the Tax Court was not convinced that Seagate's calculations of transfer prices were computed on an arm's length basis,¹⁷⁹ and the court was constrained to compute tax liability on its own.¹⁸⁰ The Tax Court's calculations, however, were far less than the tax computation made by the IRS.¹⁸¹

and Exxon and Texaco had to follow them.

174. See *infra* Part III.D for a discussion of *Perkin-Elmer v. Commissioner*, 66 T.C.M. (CCH) 634 (1993), in which the Tax Court concluded that the IRS spent a great deal of effort in the litigation attacking the allocation formula of the taxpayer, rather than establishing the soundness of the transfer pricing accounting method of its own.

175. 102 T.C. 149 (1994).

176. In this case, the IRS claimed that Seagate was overpaying for disk drives manufactured in Singapore, and undercharging its foreign subsidiary for purchasing and other services required to acquire materials in its Singaporean operations. *Seagate*, 102 T.C. 149, 165. The IRS assessed deficiencies in excess of \$112 million for a six-year period ending June 30, 1987. *Id.* at 156.

177. *Id.* at 225.

178. *Id.* at 185.

179. *Id.* at 195.

180. *Id.*

181. *Seagate*, 102 T.C. 149, 196.

Seagate foreshadows the extent of likely future problems created by the new § 482 regulations. The new regulations justify and support more than one result.¹⁸² The expanded range of possible transfer prices, coupled with enhanced penalties for choosing the wrong prices within that allowable range, virtually insure increased involvement of the courts, the rejection of the transfer price computations of both parties and the selection by the court among the various allowable outcomes.¹⁸³ The availability of such choices among transfer price accounting outcomes creates an economically unstable environment, for the regulations make it impossible for taxpayers to plan economic activities and transactions with any certainty of the consequences.¹⁸⁴ And that uncertainty is at odds with the tax system itself: a postulate of any taxation system requires that the computation of taxes be consistently and rationally determinable.¹⁸⁵ A taxation system that

182. See *supra* notes 86-115 and accompanying text for a discussion of the allowable range of prices. The same problem existed under prior transfer pricing regulations. Ron Schrotenboer, *Policy and Practical Considerations of Transfer Pricing Focus of California Conference*, TAX NOTES INT'L, Nov. 13, 1991, available in LEXIS, Taxria Library, TNI File. Schrotenboer reported on the speech of Robert Cole (of Cole, Corette and Abrutyn):

Obtaining a transfer price is inherently difficult because one can come up with a range of correct prices. Thus, a taxpayer is subject to second[-]guessing by the IRS that can appear to be legitimate. [Cole] asserted that in many cases, the IRS is now asserting abusive results. Examiners are outside of the range of arm's length prices.

Id.

183. Miller, *supra* note 114, at 44 n.206. The author summarizes statistical analysis showing that a review of regular tax court decisions over a five-year period found seven tax court judges were biased in favor of taxpayers, nine were biased in favor of the IRS, and six other judges were neither biased for nor against the IRS. Miller states that the study, however, did not explain why these differences existed, and then goes on to state that the researchers found:

The Tax Court may not be fully accomplishing its function as the unbiased arbiter of the federal income tax laws. . . . The existence of the differences described . . . suggests that the tax law sometimes means different things to different people. Whether those differences of meaning result from errors or other indicators of practical indeterminacy or from theoretical indeterminacy is not known.

Id.

184. Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 21 n.12 (1993). Green notes:

As a general proposition, indeterminate tax rules are undesirable for a number of reasons: They make it impossible for taxpayers to plan their transactions with foreknowledge of the consequences; they inevitably lead to costly and time consuming disputes about the application of the standard to the facts of particular cases; and they erode confidence in the fairness of the tax system, thereby discouraging voluntary compliance.

Id.

185. Martinez, *supra* note 166, at 240. For a discussion critical of the international acceptance and determinacy of the arm's length standard as applied to

requires taxpayers to pay an unknowable amount of tax is one that fundamentally undermines the United States system of voluntary self-compliance.¹⁸⁶

In addition, the regulations impede the ability of multinational firms to respond to rapidly changing economic conditions.¹⁸⁷ In fact, a tax-wise multinational business may well now feel compelled to override the judgment of experienced business professionals in international transactions by requiring final approval of all international sales by an international tax manager.¹⁸⁸ Such final approval is arguably necessary even for sales to unaffiliated parties, as those selling prices form the comparable transactions for selling prices to related parties.¹⁸⁹

B. IRS Determination of Transfer Prices Was Unreasonable and Inconsistent with IRS's Economic Theory in National Semiconductor v. Commissioner

The decision in *National Semiconductor Corp. v. Commissioner*¹⁹⁰ stemmed from the IRS's rejection of a transfer pricing system between the manufacturer of semiconductor products based in the United States and its Asian subsidiaries. Under the taxpayer's system, the United States manufacturing operations incurred substantial operating losses from sales to the company's affiliates

transfer pricing, see Green, *supra* note 184, at 36-44. However, the IRS would argue that the use of arm's length standard is determinate, in that it provides the theoretical underpinning for each of the various transfer pricing methods allowed. *Id.* As it is an arm's length standard, it has achieved an international acceptance and can be a "reasonably objective, determinate standard." *Id.* at 37.

186. Transfer pricing rules have long been criticized for being vague and indeterminate. See Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1219-23 (1976).

187. See generally Roland R. Davis, *The New Transfer Pricing Tax Regulations: Now That They're Here What Should You Do?*, 10 COMPUTER & HIGH TECH. L.J. 195 (1994). Davis addresses the contemporaneous documentation requirements and their implication for companies. He notes:

[S]ince high technology companies are in a rapidly developing industry, th[e] contemporaneous [transfer pricing documentation] approach . . . may prove to be particularly cumbersome since new technology products are frequently released and the intercompany prices that are charged for them will therefore vary just as often. As a result, there may not be adequate documentation prepared to substantiate the transfer price charged.

Id. at 198.

188. Davis, *supra* note 187, at 216. "The complexity and significance of these intercompany transfer pricing regulations is not to be ignored. The . . . regulations affect many facets of technology companies and any implications that they have should be dealt with prior to an IRS audit." *Id.*

189. See *supra* notes 100-15 and accompanying text for a discussion of how a taxpayer's selling prices to unrelated companies form the standard by which its selling prices to related parties are evaluated by the IRS.

190. 67 T.C.M. (CCH) 2849 (1994).

in Southeast Asia,¹⁹¹ while the Asian subsidiaries reported net profits every year.¹⁹² The Tax Court found that the IRS's determination of transfer prices was unreasonable,¹⁹³ but held that neither party had introduced satisfactory evidence of comparable selling prices to unaffiliated parties.¹⁹⁴ Accordingly, the court did not rely upon any of the prices presented by the parties to determine the appropriate transfer prices,¹⁹⁵ and instead looked to the expert financial and economic testimony introduced by the parties.¹⁹⁶

The court found the economic analyses by both parties' experts to be flawed as well.¹⁹⁷ However, the court characterized one of the IRS's economic analyses as "the least unacceptable methodology presented"¹⁹⁸ and proceeded to modify the adjust-

191. *Id.* at 2858.

192. *Id.*

193. *Id.* at 2861. Beginning in the late 1960s, National Semiconductor (as well as other semiconductor manufacturers) began moving manufacturing operations to subsidiaries in Asia. *Id.* at 2855. This move enabled semiconductor manufacturers to take advantage of lower-cost labor and overhead, as well as tax and other investment incentives provided by the local governments. *Id.* In National Semiconductor's case, the Asian subsidiaries were located in Malaysia, Singapore, Hong Kong, Thailand, Indonesia, and the Philippines. *Id.* The Asian subsidiaries packaged integrated circuits and other electronic components. *Id.* The Asian subsidiaries sold finished semiconductors and related devices to both related and unrelated parties, though the majority of the devices were ultimately sold to the U.S. parent company. *Id.* at 2857.

194. *Id.* at 2861.

195. *Id.*

196. *Id.* at 2861.

197. The court criticized both of the two economic analyses made by the taxpayer's expert. *Id.* at 2861-62. The Tax Court said the "price-to-price analysis" made by the taxpayer's expert fell short of the requirements for comparable uncontrolled prices delineated in the § 482 regulations. *Id.* Further, the court held that expert's "cost-plus analysis" failed to produce an appropriate and usable markup both under the regulations and under the specific circumstances of that case. *Id.* at 2865. Most importantly, the conclusions reached by the taxpayer's expert under his analysis were held to be unreasonable. *Id.* Thus, the taxpayer proved the IRS deficiencies were arbitrary, capricious, or unreasonable, yet the taxpayer failed to prove that its transfer pricing or proposed alternative allocations satisfied the arm's length standard. *Id.* at 2860. In addition, the Tax Court criticized the two economic analyses performed by the IRS's expert. *Id.* at 2869-71.

198. *Id.* at 2874. Tax Court Judge Mary Ann Cohen adopted the full transactional analysis of the IRS's expert, Thomas A. Horst, as "the least unacceptable methodology presented" and modified Horst's recommended adjustment where it erred and was inconsistent with the economic theory he put forward for the IRS. *Id.* Judge Cohen pointed out that Horst's economic analysis bore "no recognizable relation" to the IRS's notice amounts, and that the advancement of Horst's \$83 million adjustment undercut the notice determinations. *Id.* at 2873. Accordingly, the court held that the determinations in the IRS notice of deficiency were arbitrary and capricious, even though the court concluded that adjustments were required under § 482. *Id.* at 2860, 2873.

ment recommended by the IRS's expert where it was inconsistent with the economic theory previously put forward by that expert.¹⁹⁹ Ultimately, the court increased National Semiconductor's income under § 482 by \$40.6 million to bring the transfer prices closer to what the court said would have occurred at arm's length.²⁰⁰ The court noted that it was not presented with sufficient testimony to judge whether National Semiconductor's prices were "per se comparable to any third-party prices."²⁰¹ However, the Tax Court determined that National Semiconductor's United States operations should not have sustained losses while its Asian subsidiaries maintained high profits.²⁰² Therefore, the Tax Court concluded that an adjustment to the income of National Semiconductor was necessary.²⁰³

Many commentators and observers have criticized the United States Tax Code and accompanying regulations as being so complex as to be beyond comprehension,²⁰⁴ and desperately in need of major overhaul.²⁰⁵ At least one IRS Commissioner has argued that the entire United States system of taxation needs to be discarded.²⁰⁶ The *National Semiconductor* case illustrates that any number of expert financial and economic analyses can be used to support whatever conclusions one wishes to establish. The fact that the *National Semiconductor* court chose to characterize the IRS's economic analysis as the "least unacceptable" is bewildering in light of the increasing importance of world trade by multinational firms in today's world.

199. *Id.* at 2874.

200. *Id.* at 2873.

201. *Id.*

202. *Id.* Judge Cohen found the fact that U.S. operations were unprofitable, while Asian operations were highly profitable, to be compelling in adjusting the taxpayer's income to the U.S. operation. *Id.* She noted:

"We believe that, due to the interdependent nature of [the U.S. operation and the Asian subsidiary's operation, the taxpayer] should not have sustained losses over the years . . . while the Asian subsidiaries maintained high profits and, thus, in order clearly to reflect [the taxpayer's] income, some adjustment needs to be made."

Id.

203. *Id.*

204. Miller, *supra* note 114, at 2, 5 n.18. The United States has "the most complex income tax laws in the history of civilization." *Id.* at 5 n.18 (quoting Richard L. Doernberg, *The Market for Tax Reform: Public Pain for Private Gain*, 41 TAX NOTES 965 (1988)).

205. *Our Screwed-Up Tax Code*, FORTUNE, Sept. 6, 1993, at 34. "You'll never be able to dismantle what we have done to the system. You need to throw it in the can and come up with something new." *Id.* (quoting Paul R. Huard, Senior Vice President of the National Association of Manufacturers.)

206. *Our Screwed-Up Tax Code*, *supra* note 205 at 34. "I would repeal the Internal Revenue Code and start over[.]" *Id.* (quoting Shirley Peterson, IRS commissioner under former President Bush.)

The *National Semiconductor* court did note, however, that the IRS's allocations were generally consistent with its economic theory of the case. The court's observation was significant, as transfer pricing accounting regulations must be based upon a rational economical model, justified under economic theory but capable of practical application.²⁰⁷ The current transfer pricing accounting regulations do not reflect a justifiable and consistent rational economic theory or framework.²⁰⁸ This failure will result in increased litigation based upon the "battle of the experts" to prove the economic validity of allocations.²⁰⁹ As the economic stakes and competition among multinational enterprises escalate, and the need for additional revenues for the United States Treasury grows, almost certainly there will be a concomitant increase in protracted litigation that will only prove unsatisfactory to all parties.²¹⁰

C. *IRS Takes an Extreme Position in a Gray Area in
Exxon Corp. v. Commissioner*

In *Exxon Corp. v. Commissioner*,²¹¹ the IRS litigated a case that fell within a gray area of the law,²¹² and they began from an extreme position.²¹³ The IRS claimed that Exxon owed over \$6.5 billion and Texaco almost \$1.6 billion in additional taxes for selling Saudi crude oil below market prices to their overseas refining subsidiaries, notwithstanding that the Saudi government had dictated those prices with the approval of the United States government.²¹⁴ The five-week trial ended in May 1991; the Court

207. See *supra* notes 193-200 and accompanying text for a discussion of the court's rejection of IRS allocations as being unjustified by their economic analysis.

208. See *supra* note 185 and accompanying text for a discussion of why the IRS argues that the arm's length method forms a rational economic theory and framework for international transfer pricing allocations.

209. See *supra* notes 196-98 and accompanying text for a discussion of the use and criticism of economic experts' testimony in *National Semiconductor*.

210. See *supra* Parts I and II for discussion of the increasing internationalization of the market and the difficulties facing taxpayers in determining tax liability under the ambiguous new regulations.

211. 66 T.C.M. (CCH) 1707 (1993).

212. Gutman, *supra* note 162. Gutman cites as one of the reasons the IRS frequently loses in large tax litigation cases is that "many of the big-dollar cases are often difficult from a legal standpoint. These cases tend to be in the gray areas of the law. Taxpayers tend to be well-advised even when they take aggressive positions and have the necessary resources to support their stand." *Id.*

213. *Id.* Gutman observes that litigation problems are compounded "when the IRS starts from an extreme position. When that occurs the case is hard to settle[.]" *Id.* He adds, "According to a senior person in the chief counsel [of the IRS's] office, one reason for being hard-nosed is that the IRS does not have experts up front to evaluate a case. Thus, the initial tendency is to take an extreme position." *Id.*

214. The Saudi government, in desiring to pass along lower oil prices to consum-

issued the opinion two and a half years later in December 1993.²¹⁵ The Tax Court held that the oil companies did not have "complete power" to shift income among subsidiaries, and because Saudi law prohibited the receipt of income, the IRS could not allocate income in accordance with § 482.²¹⁶

Some commentators have suggested that extreme positions adopted by the IRS, as in *Exxon*, reflect an IRS negotiating strategy whereby IRS officials believe that starting high gives the IRS more flexibility, which will result in collecting more tax revenues for the United States Treasury in the long run.²¹⁷ One of the major consequences of allowing a range of acceptable prices under the new IRS regulations is that it permits aggressive IRS positions in transfer pricing disputes.²¹⁸ This forces wealthy multinational taxpayers facing major tax bills to litigate the extreme positions taken by the IRS.²¹⁹ The mere threatened use of enhanced transfer pricing penalties under the new regulations forms a powerful opening negotiating position for the IRS in a tax dispute with a multinational taxpayer.²²⁰ Therefore, the regulations do not clarify the multinational firm's use of transfer pricing. Rather, they virtually ensure that the resolution of tax disputes will not occur during negotiations with the IRS in the face of its aggressive challenges, but only in litigation.²²¹

ers than had been agreed upon by OPEC, asked for the cooperation of the governments of the oil consuming countries to ensure that the lower oil prices directly benefitted final consumers, rather than other parties in the chain of distribution. 66 T.C.M. (CCH) at 1715.

215. *Id.* at 1707.

216. 66 T.C.M. (CCH) at 1735.

217. Gutman, *supra* note 162. Gutman states:

Another attorney notes, there are numerous incentives and few disincentives for IRS auditors to be hard-nosed and set up big dollar issues. First, to protect the potential revenue and increase the negotiating position of the IRS many agents believe that by starting high, the IRS has more flexibility and can get more dollars in the long run. Second, to some extent, the performance award of an auditor is influenced by the size of the adjustments set up. The higher the adjustment, the bigger the potential for a bonus. At the same time, there is little downside if the auditor's adjustment is not sustained. Another reason for starting at the extreme may be the common belief, held by [IRS Audit] Examination personnel, that the [IRS] appeals office gives away from issues that [tax] auditors have worked hard to set up.

Id.

218. See *supra* notes 213, 217 for a discussion of why IRS pursues aggressive and extreme positions.

219. See *supra* note 217 for a discussion of why the IRS, in starting high during their negotiations with taxpayers, essentially forces taxpayers into the courts to resolve the large dollar tax disputes.

220. See *supra* notes 147-61 and accompanying text for a description of how the enhanced penalties can be imposed by the IRS for perceived violations of transfer pricing regulations.

221. See *supra* notes 86-146 and accompanying text for a discussion of the ambi-

D. The IRS, While Attacking Transfer Price Formulas, Fails to Establish the Soundness of its Transfer Accounting Method in Perkin-Elmer v. Commissioner

In *Perkin-Elmer v. Commissioner*,²²² the Tax Court found that the testimony and analyses of the economists and experts generally fell short of supporting the transfer prices and mark-up percentage rates advanced by both parties. The IRS had based the transfer pricing allocation amount noted on its deficiency notice by applying the cost-plus method of transfer price determination,²²³ but then abandoned this method before trial.²²⁴ The Tax Court expressed frustration with the failure by both parties to support their evidence of transfer pricing accounting methods specified in the regulations,²²⁵ noting that the parties' inability created a long and unnecessarily complicated trial.²²⁶ The court chided both parties for petty bickering and "a strategy of telling the judge as little as possible."²²⁷ However, despite the Tax Court's holding that the IRS's position was "arbitrary, capricious, or unreasonable,"²²⁸ Perkin-Elmer did not meet an arm's length standard in its transactions with its subsidiary company.²²⁹

The Tax Court held that the crucial issue was to use the correct formula to obtain an arm's length transfer price result.²³⁰ The court observed that in other § 482 cases before it in recent years, the parties to the litigation spent a great deal of effort in attacking the allocation formula of the other party, as the IRS had done in this case, rather than establishing the soundness of the transfer pricing accounting method of its own.²³¹ But the

guities inherent in the new regulations.

222. 66 T.C.M. (CCH) 634 (1993).

223. *Id.* at 655-56. See *supra* note 93 and accompanying text for a discussion of the cost-plus accounting method.

224. The use of the cost-plus method in determining the appropriate transfer price may have been abandoned because it had been rejected by the Tax Court in other transfer pricing cases. *Id.* at 657 (citing *Sundstrand v. Commissioner*, 96 T.C. 226 (1991); *Bausch & Lomb, Inc. v. Commissioner*, 92 T.C. 525 (1989); and *Eli Lilly & Co. v. Commissioner*, 84 T.C. at 1132-33 (1985)).

225. *Perkin-Elmer*, 66 T.C.M. (CCH) 634, 657. The transactions at issue were sales by and between a Puerto Rican subsidiary and its U.S. parent company, and royalties paid by the subsidiary to the parent. *Id.* at 635-36.

226. *Id.* at 657.

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.* at 657.

231. *Id.* As a result of this litigation strategy, the court observed:

"In pursuing this path, an unduly long and unnecessarily complicated trial record has been created, replete with bickering between counsel over unimportant and often irrelevant evidentiary questions and a continuance of the

court's observation demonstrates the fundamental misconception in the transfer price regulations. When any of the transfer price accounting methods allowed in the regulations is used by the taxpayer or the IRS, without a strict hierarchy in evaluating the accounting methods, none can be said to be more inherently sound than any other accounting method. Further, when a number of different accounting methods are allowed by the regulations, determination of appropriate transfer prices is increasingly apt to fall to the courts. By failing to establish a rational hierarchy of accounting methods, the new regulations are likely to exacerbate problems for both the taxpayers and the IRS.

The *Perkin-Elmer* court acknowledged this predicament, characterizing the task before it as one that was "most difficult" to perform.²³² Even the IRS recognized the uncertainty created by having a number of different accounting methods available for use by both the taxpayer and the IRS. For example, when the Tax Court concluded the taxpayer failed to demonstrate its experts came within one of the appropriate transfer price accounting methods for sales from the parent company to its subsidiary,²³³ the IRS failed to show the taxpayer's experts were wrong. The Tax Court said, "[There was no reason] to think that [Perkins-Elmer's] witnesses were wrong to a material degree in their generalizations."²³⁴ Thus, the court concluded that, "[a]fter consideration of the entire record, which is wanting on this matter through the fault of both parties,"²³⁵ the subsidiary's payments to the parent company for parts assembled into finished products were priced at an arm's length.²³⁶

'play your cards close to the chest' attitude of [taxpayer's] counsel and the lack of focus on the part of [IRS's] counsel exhibited during the discovery process."

Id.

Thus, "without benefit of sufficient help from the parties," the Tax Court had to find "precise answers based on an imprecise record." *Id.*

232. *Id.* at 657. The court noted:

The Court must find a formula, without the benefit of sufficient help from the parties as to what that formula might be. In a section 482 case, this task usually requires the Court to find a middle ground — a task which it has disavowed, in other contexts, see *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441 (1980), and one which is most difficult to perform in light of the [c]ourt's inevitable lack of knowledge of the realities of the workings of a specific industry and of the business world generally, including particularly the international competitive atmosphere which those realities reflect. It is against this background that we now turn to finding precise answers based on an imprecise record.

Id.

233. *Perkin-Elmer*, 66 T.C.M. at 678.

234. *Id.* at 677.

235. *Id.* at 678.

236. *Id.* For the subsidiary sales to the parent company, the parties agreed the

arm's length price of finished products was the resale price reduced by a markup percentage. *Id.* at 658. The resale price is ordinarily the price at which a buyer resells items in uncontrolled sales. *Id.* The markup percentage (or resale margin) is the gross profit percentage for items purchased and resold in uncontrolled transactions. However, the parties disagreed on the appropriate gross profit percentage that should have been used. *Id.* The taxpayer contended that product sales by the subsidiary should be aggregated. *Id.* The IRS argued that the products should be analyzed in three separate categories. *Id.* The Tax Court agreed with the IRS that the products should be in three separate categories, noting that the taxpayer's expert economist "did not aid" the taxpayer's case when he testified that "the more one can disaggregate the better." *Id.*, at 660.

Experts from both parties focused their economic and financial analyses on different comparable sales. *Id.* The Tax Court found that none were "an ideal fit." *Id.* However, the Tax Court evaluated these proposed comparable transactions in "descending order of value." *Id.* at 661. The court concluded that, for one category, they supported the taxpayer's contention that transfer prices charged to the parent by the subsidiary fell within the range of permissible levels under § 482. *Id.* at 666. For the other two categories, however, the Tax Court found that the appropriate gross profit margins were greater than those argued for by the taxpayer. *Id.* at 670-72.

As to parent company sales to the related subsidiary company, the parent company considered these to be sales of individual parts, each of which could be analyzed under the comparable uncontrolled profits method. *Id.* at 672. In contrast, the IRS argued that the parts were really sold as kits for assembly. *Id.* Further, the IRS contended that parts kits could not be analyzed under the comparable uncontrolled price method because the only uncontrolled sale of parts kits in the record was for less complicated instruments than those involved in this case. *Id.* The IRS also argued the resale price method did not apply. *Id.* According to the IRS, therefore, the intercompany transfer price could only be analyzed based upon the cost-plus method. *Id.*; see also *supra* note 93 and accompanying text. Under the cost-plus method, the arm's length price of a sale between related parties is the direct and the indirect cost of producing the property increased by an appropriate gross profit percentage. *Id.* This profit percentage is generally derived from uncontrolled sales that are most similar to the controlled sale. *Id.* Finding similarity generally involves looking at the various functions performed by the seller. *Id.* The Tax Court characterized the IRS's parts kit approach as "novel and complex." *Id.*

The IRS argued the appropriate gross profit markup by the parent company on the part kits corresponded to the gross profit markup the parent company subsequently achieved on sales of the finished product. *Id.* According to the Tax Court, the foundation of this position was the "purported" comparability of a parts kit and the finished product into which the kit was assembled. *Id.* The IRS argued that, though a parts kit and a finished product were much different in terms of physical appearance, they both embodied the same manufacturing intangibles as the product itself. *Id.* The IRS stated the manufacturing intangibles included "technology, know-how, an experienced engineering staff, a vertically integrated structure that allowed a cost-efficient operation, an ability to innovate and respond to market demands for new techniques, and an extensive purchasing, production planning, and inventory control system." *Id.* at 672 n.19.

The court allowed that the "parts kit system was how [the parent and subsidiary companies] communicated." *Id.* at 674. However, the court also noted that the subsidiary company benefited from the manufacturing intangibles of the finished product. *Id.* Nevertheless, the Tax Court declined to accept the parts-kit concept in determining an arm's length price for the parts. *Id.* The Tax Court held that because there was no outside market for the parts kit, the IRS's approach to deter-

PROPOSAL

Section 482 gives the IRS authority to make adjustments where a taxpayer's transfer price is inconsistent with an arm's length standard. The recently issued IRS transfer pricing regulations muddle, rather than clarify, what is meant to be the regulatory guidance to assist taxpayers in averting such an adjustment. The IRS believes that by establishing more exacting standards, these regulations will assure that the division of income between related parties reflects the economic activities each undertakes. However, the regulations come close to imposing a requirement that taxpayers set prices not for business reasons, but for tax reasons, a result exactly opposite of the IRS's intent.

This Note proposes that the Internal Revenue Service rescind the regulations requiring taxpayers to document all economic and pricing analyses under all of the alternative transfer pricing accounting methods. Most multi-jurisdictional companies sell far too many products to consider the tax consequences of each transaction. The extensive documentation requirements of the regulation are superfluous, needlessly burdensome and of dubious value in a § 482 examination.

On the other hand, it is entirely appropriate for a taxpayer to select and to document transfer pricing based upon one of the accounting methods allowable under the regulations. This Note proposes, therefore, that a taxpayer who selects an international transfer price within the reasonable range, and who uses any one of the accounting methods allowable under the regulations, should be deemed to have established the *prima facie* validity of the taxpayer's chosen transfer price. This Note proposes further that the IRS, in challenging that price, should establish the soundness of the IRS's own transfer price accounting method, rather than merely attacking the taxpayer's formula.

Finally, this Note proposes that the United States Congress

mining the gross profit markup "involve[d] practical difficulties and unsupported assumptions that we cannot ignore." *Id.*

Perkin-Elmer contended the arm's length price was the total of all arm's length prices for the individual parts, plus an adjustment based upon the parent company's purchasing, inventory and freight forwarding activities. *Id.* at 676. The company argued that even after the upward adjustment, the gross profit markup paid to the parent company by the subsidiary exceeded the upward adjustment. *Id.* Therefore, the taxpayer argued, no § 482 adjustment was required for these sales and the comparable uncontrolled price analysis supported its position. *Id.* The Tax Court noted that for establishing comparable uncontrolled sales, the transfer pricing regulations required evaluation of the physical property and circumstances of the comparable sales. *Id.* The Tax Court concluded that the company's disregard of the circumstances that should have been considered caused it to "fail to come within the comparable uncontrolled price method." *Id.* at 677.

restore the "reasonable cause and good faith" exception to imposition of tax penalties under § 482. A tax penalty is fair and just only when the taxpayer clearly understands what he is required to do. The current regulations allow the IRS to impose enhanced penalties for violations of ambiguous regulations. The imposition of IRS penalties for taxpayers who select reasonable transfer prices consistent with the accounting methods allowed under the regulations is entirely inappropriate.

CONCLUSION

The IRS believes that the more stringent transfer pricing standards of the new § 482 regulations will lead to less litigation in the future. Perhaps because IRS allocations are presumed correct, the IRS expects to prevail when litigation is required. However, as the volume of international trade grows, and the competitive stakes to multinational taxpayers increase, the IRS will find its hope is misplaced. For in providing numerous transfer pricing methods that result in a range of reasonable transfer prices, none of which is more inherently sound than the others, the IRS has created an unworkable tax environment that will continue to require that courts choose among various possible outcomes. Unless the § 482 regulations are modified in accordance with the proposals indicated in this Note, the new regulations will lead to more, not less, litigation that is likely to result in a continuing and persistent pattern of defeat for the IRS.

*Michael Auramovich**

* To my mother and father, whose love and example helped me become what they believed me to be, and to my wife, Susan, whose love and encouragement has always been my inspiration.