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The Transfer Pricing Regs Need a Good Edit

Susan C. Morse*

I. INTRODUCTION

Under current U.S. tax law, U.S.-parented multinational corporations (MNCs) have a lot of tax planning flexibility. This is due in part to transfer pricing regulations that maximize taxpayers’ planning options. Intellectual property-rich companies have drawn recent Congressional attention in part because of aggressive transfer pricing, although planning opportunities are

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* Associate Professor, UC Hastings College of the Law. Many thanks for helpful comments to Ilan Benshalom and to participants in the Tax Advice for the Second Obama Administration symposium cosponsored by the Pepperdine Law Review and Tax Analysts, particularly to co-panelists Reuven Avi-Yonah, Allison Christians, and Robert Goulder. This article is part of Pepperdine Law Review’s January 18, 2013 Tax Advice for the Second Obama Administration symposium, co-sponsored by Tax Analysts.

not limited to the Apples and Googles of the world. Transfer pricing problems would persist regardless of the outcome of reform proposals on the table, including the possibility of “territorial” exemption of non-U.S. business income and related dividends from non-U.S. subsidiaries and the Obama Administration’s suggestion of a low but non-zero tax rate on foreign earnings.

Taxpayers exploit information asymmetry and regulatory complexity advantages in their aggressive application of transfer pricing regulations. But the government has important tools that it can use to address these problems. This Article contributes to this symposium collection of tax advice for the second Obama Administration by advocating the use of regulatory discretion to edit the transfer pricing regulations and reduce corporate taxpayers’ flexibility to allocate taxable income away from U.S. affiliates and income tax deductions toward U.S. affiliates. Others have developed specific proposals for the incremental adoption of formulary apportionment methods to help reform transfer pricing. This Article seeks to explain and emphasize the important role that U.S. tax regulations have played in enabling transfer pricing planning, and to encourage tax administrators to exercise their considerable power to give the transfer pricing regs a badly needed edit.

Part II of this Article describes the statutory and regulatory framework under Section 482, which provides for transfer pricing and related rules that allocate income and deductions among affiliates within a related MNC group. Section 482 is a broad statute accompanied by long and detailed

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6. See infra Part II.
regulations. Part II also illustrates the approaches taxpayers take in assigning income and deduction items, which depend on an exploitation of taxpayers’ information advantages relative to the government and on the details of the regulations.

Part III argues that amending the transfer pricing regulations could constrain taxpayers’ planning options, for example by incorporating rules that refer to non-tax, high-friction data points. The Article envisions edits to the transfer pricing rules that incrementally add formulaic elements to the rules without adopting a formulary global transfer pricing standard. Incremental formulaic rules depart from the headline arm’s length transfer pricing message of the Organisation for Economic Co-Operation and Development (OECD) and bear some similarity to transfer pricing approaches in non-OECD countries such as Brazil, China and India.

Nevertheless, such an incremental approach should not produce intolerable tensions with U.S. commitments to an arm’s length standard in treaties and as a member of the OECD. OECD white papers have begun to adjust the conception of the arm’s length standard and hint at incremental formulaic elements. U.S. treaty partners might also benefit from incrementally formulaic rules that limit taxpayers’ ability to contractually allocate income away from tax haven jurisdictions.

II. GENERAL STATUTE, SPECIFIC REGULATIONS

A. The Baseline: Low U.S. Tax on Non-U.S. Income

Corporations incorporated in the U.S., for example in a U.S. state such as Delaware, are subject to U.S. federal income tax on worldwide income. A typical U.S.-parented multinational corporation structure features a U.S. corporate parent that owns non-U.S. operating subsidiaries through intermediate low-tax corporations. Because the U.S. rules treat separately

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7. See infra Part II.C.
8. See infra Part II.D.
9. See infra Part III.
incorporated affiliates as separate taxpayers, non-U.S. corporate subsidiaries of a U.S. parent are not automatically required to pay U.S. federal income tax on all of their income.\textsuperscript{12}

Under applicable anti-deferral rules, a U.S.-parented MNC currently must pay tax on the income of its foreign subsidiaries to the extent such income falls into the definition of “subpart F income.”\textsuperscript{13} It must also pay U.S. income tax on dividends repatriated from non-U.S. subsidiaries.\textsuperscript{14} U.S. tax due on both subpart F inclusions and repatriated dividends is subject to reduction under applicable foreign tax credit provisions.\textsuperscript{15}

U.S.-parented MNCs face an incentive to engage in planning to reduce U.S. corporate income tax, including by (1) minimizing subpart F income,\textsuperscript{16} (2) minimizing taxable repatriations, (3) maximizing the tax savings of foreign tax credit planning,\textsuperscript{17} (4) using treaty-shopping, “sandwich” planning, check-the-box elections and other strategies to leverage the U.S. network of bilateral income tax treaties and arbitrage differences between U.S. and non-U.S. law,\textsuperscript{18} and (5) exploiting U.S. transfer pricing and deduction allocation and apportionment rules.\textsuperscript{19} It is estimated that U.S. tax is imposed currently on non-U.S. business income earned by non-U.S.

\textsuperscript{12} See, e.g., Moline Props., Inc. v. Comm’r, 319 U.S. 436, 438–40 (1943) (finding that a parent corporation and its subsidiary are generally separate taxable entities, with some exceptions, such as if the subsidiary is a sham or acts as a mere agent of the parent).

\textsuperscript{13} See I.R.C. § 951(a) (2006). Subpart F is intended to describe most categories of mobile and passive income. See, e.g., Stephen E. Shay, Exploring Alternatives to Subpart F, TAXES, Mar. 2004, at 29, 30 (referring to subpart F’s targeting of passive and base company income).

\textsuperscript{14} See Shay, supra note 13, at 31.


\textsuperscript{17} See Grubert & Altshuler, Corporate Taxes, supra note 15, at 347 (emphasizing the importance of a firm’s foreign tax credit position); Kleinbard, supra note 11, at 725–26 (describing the foreign tax credit “distillery”).

\textsuperscript{18} See, e.g., Kleinbard, supra note 11, at 707–13; see Jesse Drucker, Google’s 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes, Bloomberg (Oct. 21, 2010), http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.

\textsuperscript{19} See, e.g., Kimberly A. Clausing, Multinational Firm Tax Avoidance and Tax Policy, 62 NAT’L TAX J. 703, 703–04, 711, 717 (2009) (estimating “financial” income-shifting and “real” productive asset location-shifting responses to higher U.S. tax rates and concluding that the financial effects—producing lost tax revenue of about $87 billion in 2002—were more than double the real effects).
subsidiaries in MNC groups at a rate of between 3% and 6%. The ability of firms to erode the U.S. tax base through such planning leads to the conclusion that the current U.S. system raises less tax revenue than would a territorial or exemption system that refrained from taxing non-U.S. business income, but included careful allocation rules that diminished U.S.-parented MNCs’ ability to reduce U.S. taxable income.

This Article focuses on planning under the transfer pricing regulations. U.S. tax administrators can use their regulatory discretion to combat taxpayers’ planning efforts under these rules and restrict the “freedom of contract” options available to taxpayers to allocate income to low-taxed non-U.S. affiliates, and conversely to allocate deductions away from low-taxed non-U.S. affiliates and to U.S. operations. These transfer pricing challenges will continue either in the current system or in the event of reform. In fact, if the U.S. adopted a territorial or dividend exemption system, transfer pricing rules might be even more important, since after a U.S.-parented MNC initially allocated business income to a low-tax jurisdiction, it would not face the possibility of residual U.S. tax on repatriated dividends.

Proposals like the one presented in this Article—which would tighten U.S. tax rules applicable to U.S.-parented MNCs—raise the concern that the tighter rules might cause a more serious economic problem than the public finance challenge caused by reduced corporate income tax revenue. In other words, MNCs might respond by moving their businesses—not just their

20. See Harry Grubert & John Mutti, Taxing International Business Income: Dividend Exemption Versus the Current System 31–32 (2001) (reporting a 3.3% estimate for the overall burden of a dividend repatriation tax assuming an excess limitation foreign tax credit position and a non-U.S. effective tax rate below 10 percent); Rosanne Altshuler & Harry Grubert, Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations, 54 Nat’l Tax J. 787, 797 (2001) (calculating a rate of 5.4% based on certain assumptions drawn in part from 1992 Treasury tax return data; the rate also reflects the assumption that intangible assets produce royalty income that bears the full U.S. top statutory rate for excess limitation firms).


23. See, e.g., Graetz & Oosterhuis, supra note 3, at 776 (noting transfer pricing’s possible role in distinguishing between passive and mobile non-U.S. income).
taxable income—elsewhere. For example, perhaps U.S.-headquartered MNCs might start incorporating parents outside the U.S.

This Article sets this concern about business location decisions aside. Non-tax considerations are very important to such location choices and so it is difficult or impossible to predict the impact of tax rule changes on business location. In addition, the solutions recommended here are incremental steps that could be adjusted after initial implementation in response to evidence about the reaction of MNCs and the reaction of other countries that might attract MNC business.

24. Clausing, supra note 19, at 704 (reporting that MNC tax planning results in significantly more lost U.S. tax revenue than “real responses”); Harry Grubert, Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, Not Sales, Are Being Globalized, 65 Nat’l Tax J. 247, 278 (2012) (reporting that lower foreign effective tax rates produce the result that MNCs allocate more profit to non-U.S. affiliates, but do not produce the result that sales shift from the U.S. to non-U.S. markets).


B. No Truth in Transfer Pricing

The OECD,\(^28\) the U.S.,\(^29\) the European Union (EU),\(^30\) and the United Nations\(^31\) —among others—reference the arm’s length standard as an appropriate benchmark for the assignment of income and deduction items to different affiliates of a multinational. However, as others have observed, a literal understanding of the arm’s length standard is theoretically bankrupt.\(^32\) Available benchmarks from third-party transactions do not provide a sufficient basis for allocating items among corporate affiliates.\(^33\) The core problem is this: If business firms exist in order to integrate management and production functions, realize cost savings, and produce better results, then at least some of the profit subject to allocation in the related party situation simply does not exist in any unrelated “comparable.”\(^34\)

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\(^28\) See, e.g., ORG. FOR ECON. COOP. & DEV., TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, at I-6 (2001) [hereinafter TRANSFER PRICING GUIDELINES] (“[T]he view of OECD Member countries continues to be that the arm’s length principle should govern the evaluation of transfer prices among associated enterprises.”).

\(^29\) See, e.g., Treas. Reg. § 1.482-1(b)(1) (2012) (“In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer.”).

\(^30\) See Wolfgang Schön, Transfer Pricing, the Arm’s Length Standard and European Union Law, in ALLOCATING TAXING POWERS WITHIN THE EUROPEAN UNION 77 (Isabelle Richelle, Wolfgang Schön & Edoardo Traversa eds. 2013) (citing Case C-311/08, Société de Gestion Industrielle SA v. Belgium, 2010 E.C.R. I-00487, decided by the European Court of Justice, which referenced the arm’s length standard as an appropriate tool to combat “abusive arrangements”).


\(^32\) See, e.g., Ilan Benshalom, Sourcing the “Unsourceable”: The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions, 26 VA. TAX REV. 631, 641–45 (2007) [hereinafter Benshalom, Unsourceable] (noting the “theoretical deficiency” and “enforcement deficiency” of the arm’s length standard). See also Avi-Yonah, Clausing & Durst, supra note 5, at 500; Vann, Hard-Boiled, supra note 22.

\(^33\) See generally REUVEN S. AVI-YONAH, INTERNATIONAL TAX AS INTERNATIONAL LAW 111 (2007) (“[I]t became clear by the late 1980s that the traditional methods for addressing transfer pricing problems were not sufficient because in the vast majority of cases they were not being applied in a satisfactory way.”).

A search for a fundamental theory of transfer pricing also draws little help from ideas about the proper source of income. Commentators have observed that determining income or deduction source, or the “economic allegiance” of an item of income or deduction, is theoretically intractable, or at least so hopelessly factually entwined as to be impossible to untangle. “Income . . . attaches to someone or something that consumes and that owns assets” or produces value through labor; “[i]ncome does not come from some place.” It is a fallacy to presume that a tax rule could unravel the complex web of factors supporting productive economic activity and even approximately determine a “correct” economic source for items of income and deduction, at least in most relevant cases presented by global business fact patterns.

It cannot be theoretically correct, for example, to say that interest income paid by a multinational corporate borrower owes primary “economic allegiance” to the place of incorporation of the MNC’s parent corporation. The MNC’s global business supports the interest payment. That global business in turn presumably owes “economic allegiance” not only to every place in which the MNC produces goods or services and every place in which the MNC’s customers reside, but also to every place in which its employees were educated, its property defended by relevant laws, the raw materials needed to support its venture supplied or protected, and so forth.

C. Section 482: Statute and Regs

Despite the lack of a satisfying fundamental basis for the assignment of items of income and deduction among affiliates or among source countries, the U.S. rules (like other countries’ rules) must of course attempt the task. Section 482 is the main U.S. statutory provision governing the assignment of items of income to different affiliates of an MNC under transfer pricing principles. It is very broad, and accordingly rather short relative to its role in dividing jurisdiction to tax. The core of Section 482 provides as follows:

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38. See Kleinbard, supra note 11, at 750–52 (describing “the fruitless search for source”).
The Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among [two or more organizations owned or controlled directly or indirectly by the same interests], if he determines that such distribution, apportionment, or allocation is necessary in order . . . clearly to reflect the income of any of such organizations . . . .

Another portion of Section 482 provides that “the income with respect to such transfer or license [of certain intangible property] shall be commensurate with the income attributable to the intangible.”

This broad statute supports considerable regulatory discretion. Discretion is granted to tax administrators by the very terms of the statute. But the regulatory discretion supported by this generously worded statute has, to date, largely been wasted. The regulations under Section 482 are long and complicated. They give too much away, in large part because they permit taxpayers to whip saw the government at every turn by (1) choosing the most advantageous income and deduction assignment and sourcing methods for each particular set of taxpayer facts and (2) massaging the facts, for example through valuation analysis, to further improve the results.

For example, the “dash four” and “dash seven” regulations promulgated under Section 482 apply to intangible property, including intellectual property (IP) such as patents, knowhow, trade secrets and the like. These regulations provide no fewer than six possible methods to use to determine

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41. Id. Section 861(b), relating to the sourcing of deductions, is similarly broad; it provides that U.S.-source income shall be reduced by “the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income.” I.R.C. § 861(b). An analysis of this provision lies outside the scope of this Article, though some of the observations relating to the enforcement disadvantages of taxpayer optionality have also been made in the deduction allocation context. See Daniel Shaviro, Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals, 54 TAX L. REV. 353, 354–56 (2001) (acknowledging a preference among commentators for “allocation to tracing”—in part because allocation is “less easily manipulated through tax planning”—but arguing that other factors are also important to the interest allocation rule, such as the approach taken by trading partners); see also Michael J. Graetz, A Multilateral Solution for the Income Tax Treatment of Interest Expenses, 62 BULL. FOR INT’L TAX’N 486 (2008).
42. See supra text accompanying note 41; see also I.R.C. § 7805 (2006) (granting authority to “prescribe all needful rules and regulations for the enforcement of [the Code]”).
43. Goodwill and going concern value are not included in the cross-referenced statutory section that limits the “commensurate with income” statutory provision contained in the statute’s second sentence. See I.R.C. §§ 482, 936(h) (2006). They are also not listed in the definition of “intangible,” contained in the dash four regs. See Treas. Reg. § 1.482-4(b) (2011).
the payment made between affiliates for IP. For example, in a U.S. parent–
non-U.S. subsidiary structure, the U.S. parent may license IP rights to the
non-U.S. subsidiary in exchange for royalties priced under the comparable uncontrolled transaction, comparable profits, profits split, or another “unspecified” method under the USM regs.44 A non-U.S. subsidiary may purchase a “buy in” interest in existing IP from the U.S. parent and pay a sum determined by an IP valuation that considers factors including relative U.S. and non-U.S. sales.45 Finally, the MNC may use a cost-sharing agreement for IP to be developed in the future, which requires the non-U.S. subsidiary to pay a share of the development costs proportional to the percentage of future benefits expected to be generated from the non-U.S. subsidiary’s share of the IP, for example as a result of non-U.S. revenue.46

D. Planning Under the Section 482 Regulations

The U.S. government’s losses in two recent transfer pricing cases illustrate the ability of taxpayers to exploit what Richard Vann has called “[a] major structural flaw in current rules[,]” which is “the freedom of contract that is permitted to associated corporations.”47 In Xilinx, the taxpayer, a U.S. parent corporation, entered into a cost sharing agreement to create joint intellectual property ownership with a non-U.S. subsidiary.48 In Veritas, the government asserted that a U.S. parent corporation had undervalued intellectual property transferred to a foreign subsidiary; the government alleged that the taxable gain on transfer should correspondingly increase.49

Under the Xilinx agreement, all deductions relating to the exercise of employee stock options were allocated to the U.S. parent.50 These deductions can be extremely large, as anecdotal cases of such deductions minimizing or eliminating high-technology firms’ taxable income demonstrate.51 When the government finally brought suit, it ultimately lost on rehearing before the Ninth Circuit. The taxpayer’s argument—that an arm’s length agreement between third parties would not have shared stock

45. See Treas. Reg. § 1.482-7(a)(2) (2012) (outlining rules for platform contribution transactions). These transactions are also known as “buy-ins.” Brauner, supra note 34.
47. See Vann, Hard-Boiled, supra note 22, at 339.
48. Xilinx Inc. v. Comm’r, 567 F.3d 482, 484 (9th Cir. 2009), rev’d on reh’g, 598 F.3d 1191 (9th Cir. 2010), acq. in result AOD 2010-03.
49. See Veritas Software Corp. v. Comm’r, 133 T.C. 297, 312 (2009), nonacq. AOD 2010-49.
50. Xilinx, 567 F.3d at 485.
option costs—carried the day. However, the arm’s length question was entirely counterfactual, since third parties would not have shared ownership of the underlying intellectual property, which was the software at the heart of Xilinx’s business.

For purposes of this Article, the most interesting thing about the Xilinx case is the fact that the government got trapped in its own regulation and in its own relatively vague adoption of a headline “arm’s length” standard at the top of those regulations, without appropriate constraints throughout the rules as to what it meant by “arm’s length.” Nevertheless, the government successfully executed an end run around the arm’s length standard for future stock option expense. It did this simply by redefining what it meant by “arm’s length,” and providing that employee option costs had to be shared in cost sharing agreements going forward, in order to comply with the regulations that defined the arm’s length standard.

The Veritas case presented the issue of the valuation of technology transferred from a U.S. parent to a foreign subsidiary in a “buy-in” transaction. The government could not rebut the taxpayer’s argument that the value of the technology—extremely high in hindsight—derived from more recent improvements made after the buy-in rather than from the originally developed IP initially transferred from parent to sub. Like the Ninth Circuit in Xilinx, the Tax Court in Veritas concluded that the government was backed into a corner by its own regulations. The regs required valuation at the moment of transfer—rather than, for example, taking a cue from the statute and requiring the payment of variable royalties “commensurate with the income” of the intangible. Valuation is a fact-

52. Xilinx, 598 F.3d at 1197 (Fisher, J., concurring).
53. See Reuven S. Avi-Yonah, Xilinx Revisited, 59 TAX NOTES 1621, 1621 (March 29, 2010).
54. See Treas. Reg. § 1.482-7(a)(4), (d)(1)(iii), (d)(3) (2012). Altera Corporation has challenged the ability of Treasury regulations to redefine “arm’s length” in the revised stock option cost sharing regs. See Petition of Altera Corporation at 27-28, Altera Corp. v. Comm’r, Nos. 6253-12, 9963-12 (Tax Ct. Mar. 6, 2012) (arguing that unrelated parties would not share stock options costs because of such costs’ volatility, the lack of relationship between such costs and research and development, and the incentives that such sharing would present for stock price manipulation). In Altera, the government has the advantages of the broad discretion granted in the statute, see supra Part II.C (describing Section 482), together with the applicability of Chevron deference as confirmed in Mayo. See infra Part III.B (discussing Mayo and Chevron).
56. See id. at 323–24.
57. See, e.g., Veritas, 133 T.C. at 323–24 (“No buy-in payment is required for subsequently developed intangibles.”).
intensive question, and all of the facts are at the ready command of the taxpayer rather than the government.\textsuperscript{58}

The government has also tried to address the problem of buy-in pricing exemplified by Veritas through regulation. However, it made the mistake of operating within the pre-existing model of permitting IP transfer through a “buy-in.” It developed the concept of a “platform contribution transaction” (PCT), in an attempt to require taxpayers to more highly value U.S.-developed IP and other value transferred from a U.S. parent to a non-U.S. subsidiary. Under the PCT regulations,\textsuperscript{59} the fact-specific game is tilted a bit more toward the government, but significant freedom of contract valuation flexibility remains in the hands of the taxpayer to determine the value of intellectual property at a moment of transfer. A regulatory change that tied taxpayer results to an independent metric would do more to reduce taxpayers’ planning opportunities.\textsuperscript{60}

\section*{III. CHANGE THE REGS TO GIVE TAXPAYERS LESS FREEDOM}

\subsection*{A. The Current Regs Only Look Like Rules}

A brief consideration of the contrast between rules and standards helps to explain this Article’s recommendation to make the transfer pricing regulations operate more like rules and less like standards. Rules are said to substantially constrain decision-maker choices\textsuperscript{61} and to permit those subject to the rules to “know what the rules are without adverting to basic principles.”\textsuperscript{62} A related view is that rules provide the substance of a law before affected stakeholders act, while standards provide content after those affected act.\textsuperscript{63}

Under these definitions, the transfer pricing rules look more like standards and less like rules, despite their length and use of specific

\textsuperscript{58} See, e.g., Brauner, \textit{supra} note 34, at 110 (noting problem of “information asymmetry”). Despite the disadvantages the government faces in fact-intensive buy-in valuation challenges, it has continued to pursue them. See, e.g., Julie Martin, \textit{Amazon Fighting IRS Over Cost-Sharing Agreements}, 69 TAX NOTES INT’L 223 (Jan. 21, 2013) (reporting IRS deficiency calculation of over $200 million based on valuation of transferred intangibles under a discounted cash flow method).

\textsuperscript{59} See Treas. Reg. § 1.482-7(b)(1)(2), (c), (g) (2012) (providing PCT valuation methods including the income, acquisition price, market capitalization, and residual profit split methods).

\textsuperscript{60} For example, Benshalom proposes determining the ownership of IP based on the location of employees that work in research and development. See Benshalom, \textit{Unsourceable}, \textit{supra} note 32, at 682.


definitions and precise methodology. Taxpayers’ known ability to plan around the transfer pricing regs, the government’s inability to curtail such planning, and taxpayer-favorable outcomes in recent transfer pricing cases all support the conclusion that the regulations do not substantially constrain taxpayer choices with respect to transfer pricing. Nor can it be said that taxpayers or the government “know what the rules are without adverting to basic principles,” as neither can determine the content of the rule without reference to the basic, although fictional, principle of arm’s length pricing. Finally, the regulations fail to specify transfer pricing results and leave that question to ex post determinations to be made based upon after-the-fact experience with the rules as promulgated.

Yet, because the transfer pricing regulations are specific and complex, they exhibit some of the disadvantages of rules as well. Although greater complexity is sometimes expected to increase certainty by matching efficient and/or fair consequences to increasingly specific facts, rules cannot anticipate every transaction. And because of tax planning, transactions that might be uncommon before tax rules come into force can become common after the fact. This occurs as taxpayers exploit less- and more-favorably taxed similar or “close substitute” transactions by moving toward the less-taxed category, if doing so does not implicate significant nontax “frictions.” In transfer pricing, for example, the enormous effort put into articulating different ways to allocate and compensate the use of intellectual property permits taxpayer to choose among buy-in, cost-sharing, licensing, and other intercompany agreement models to, among other goals, optimize tax results.

The underlying problem is that the transfer pricing regulations are drafted as if they are grounded in the standard of arm’s length pricing, but this standard is a sad fiction rather than a fundamental guidepost. The arm’s length standard and the concept of income source have proven wholly inadequate to the task of providing a basic principle to underpin a transfer

64. Sunstein, supra note 62, at 969.
65. See David A. Weisbach, Formalism in the Tax Law, 66 U. CHI. L. REV. 860, 869 (1999) (“Uncommon transactions that are taxed inappropriately become common as taxpayers discover how to take advantage of them.”).
67. E.g., David M. Schizer, Frictions as a Constraint on Tax Planning, 101 COLUM. L. REV. 1312, 1323–25 (2001) (noting that frictions such as business decisions, technology limitations, and high transaction costs limit tax planning).
pricing standard, and decided cases evidence the U.S. government’s inability to effectively use the arm’s length standard as a tool to counteract aggressive transfer pricing. The project of writing transfer pricing regulations as standards lacks promise in the absence of any fundamental guideline for the allocation of affiliated group income.

For similar reasons, anti-abuse rules do not present a particularly promising path. Such rules often draw on the idea that the statute pursues a coherent purpose. But here it cannot be said that a theoretically correct assignment of income or deductions among affiliated taxpayers exists. An anti-abuse rule accordingly would likely lack the principled underpinning that would permit it to provide a general solution to transfer pricing problems, although such a rule could be used as an enforcement device in extreme cases.

The best option is to promulgate specific changes to the transfer pricing regulations that move away from standard status and toward rule status. A transfer pricing regulatory project in the second Obama Administration should move toward real rules, rather than complicated worse-than-rule standards that fail to provide ex ante content and permit taxpayers to arbitrage close-substitute differences generated by the specificity of the rules. It should consider incremental formula-based transfer pricing reform that constrains taxpayers’ planning options, for example by anchoring results on nontax, high-friction reference points.

B. Why Regulation?

U.S. tax administrators have a range of options in their guidance toolbox. They may pursue statutory changes; promulgate notice-and-

68. See supra Part II.B (explaining the inadequacy of arm’s length and economic allegiance concepts for the task of dividing jurisdiction to tax).

69. See supra Part II.D.


71. See supra Part II.B (arguing that neither the arm’s length standard nor source-of-income concepts provide a principled basis for dividing jurisdiction to tax).

72. For example, in SGI, the arm’s length principle was used to impute interest on an interest-free related party loan. Case C-311/08, Société de Gestion Industrielle SA v. Belgium, 2010 E.C.R. I-00487.

comment regulations, which receive maximum deference under the *Chevron* standard;\(^74\) write Revenue Rulings and Revenue Procedures, which are commonly understood to articulate the government’s litigation position and are subject to less deference;\(^75\) and provide notice that the government will undertake future actions such as forthcoming guidance.\(^76\) In addition, the government can attempt to enforce its view retroactively as well as prospectively through litigation.\(^77\)

Regulation is the right tool for the job of improving the U.S. rules that assign items of income and deduction among MNC affiliates. This is because the existing problems in this area arise from the optionality and complexity contained within the transfer pricing regulations themselves. The root cause of the problem will not go away until the regs are changed, as *Xilinx* and *Veritas* illustrate.

Revised regulations promulgated under a notice-and-comment standard would receive strong deference. In 2011, the Supreme Court made clear in *Mayo*\(^78\) that the generally applicable *Chevron*\(^79\) standard of deference applies to tax regulations just as it does to other federal regulations. Section 482 delegates authority and is “ambiguous” with respect to “the specific issue” of how, exactly, income and deductions are to be assigned among commonly controlled affiliates, and so any “permissible construction of the statute” would stand under *Chevron*,\(^80\) even if it represented a change from previously promulgated guidance.\(^81\)

revenue rulings, 169 revenue procedures, and 292 notices over a three year period. See *Mann*, supra, at 896.


76. *See Mann*, *supra* note 73, at 896 (nothing the publication of 292 Notices over three years).

77. *See Mann*, *supra* note 73, at 894 (identifying the joint role of IRS Chief Counsel and Department of Justice attorneys in deciding what cases to litigate).


80. *Id.* at 842–43.

81. *Cf.* *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 140 (1944) (providing the standard sometimes invoked pre-*Mayo* in the review of tax regulations and considering among other factors “consistency with earlier and later pronouncements”). *Mayo* clearly applies to final regulations promulgated after
The relatively slower pace of notice-and-comment regulatory change relative to other administrative action—such as Notice practice—is part of the price of fixing an existing regulatory problem. Yet regulatory change has certainty and process advantages over other, non-administrative courses of action. Regulation faces fewer public choice challenges than Congressional lawmaking. Regulation carries less outcome uncertainty than litigation. And because the regulatory process is unilateral, it can be carried out more quickly than bilateral treaty negotiations.

Finally, the capacity of the regulatory process to engage in systematic analysis may permit it to do a better job than would other courses of action in limiting what David Schizer has termed “planning options” and Richard Vann calls “freedom of contract” under existing regulations. In general, a tax planning option is more valuable if it offers more possible outcomes, “because the well-advised taxpayer is more likely to find an especially favorable one (while avoiding unfavorable ones).” Regulation has an advantage relative to Revenue Ruling and Revenue Procedure guidance and litigation because it has the capacity to more comprehensively address the subject at hand. In contrast, more limited methods of guidance that target particular transactions rather than broader prospective solutions have the

notice-and-comment. See, e.g., Lederman, supra note 75, at 661–63 (2012) (noting remaining uncertainty if these elements are not met).

82. The promulgation of tax regulations should follow the relatively involved “notice and comment” regulatory process prescribed by the Administrative Procedure Act. See Kristin E. Hickman, Coloring Outside the Lines: Examining Treasury’s (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements, 82 NOTRE DAME L. REV. 1727, 1732–40 (2007) (outlining Administrative Procedure Act and I.R.C. § 7805 requirements as applied to Treasury regulations). Regulations take more time to implement, generally apply only prospectively, and are more difficult to change. Several preview devices exist for minimizing the disadvantages of a delayed and complex regulatory process resulting from these limitations. Notices, for example, can be used to pre-announce intended regulatory changes without overspecifying them. The government can also use proposed regulations (which technically announce the government’s position and are not binding) and temporary regulations, with their official shelf life of three years. Richmond, supra note 73.

83. See Martin A. Sullivan, Corporate Tax Reform (2011); Jennifer Arlen & Deborah M. Weiss, A Political Theory of Corporate Taxation, 105 YALE L.J. 325, 336–38 (1995) (arguing that managers have incentives to favor policies that encourage additional investment or otherwise make possible increases to individual returns such as salaries); Michael Doran, Managers, Shareholders, and the Corporate Double Tax, 95 VA. L. REV. 517, 536–42 (2009) (citing “unevenness resulting from the different use of corporate tax preferences, interest deductions, and tax shelters”).

84. Schizer coined the term “planning option” to describe taxpayers’ capacity to tax plan by restructuring transactions and considered the concept in the context of tax shelters and derivative transactions. See David M. Schizer, Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning, 73 S. CAL. L. REV. 1339, 1344–45 (2000) (distinguishing the “planning option” from the “timing option” offered by decisions such as when to sell an appreciated investment position (citing George M. Constantinides, Capital Market Equilibrium with Personal Tax, 51 ECONOMETRICA 611, 621–23 (1983))).

85. See Vann, Hard-Boiled, supra note 22.

86. Schizer, supra note 84, at 1351.
potential to increase regulatory complexity and thus increase taxpayers’ planning options.

Although regulation practice is within tax administrators’ discretion, it is not immune from Congressional influence and lobbying. Two 1998 examples illustrate successful efforts to “lobby the regs.” In Notices 98-5 and 98-11, the IRS and Treasury stated that they would write regulations foreclosing certain international arbitrage opportunities in, respectively, the foreign tax credit and subpart F areas.87 The entity classification “check-the-box” rules promulgated in 1996 had recently made these arbitrage opportunities widely available.88 A firestorm of protest erupted in reaction to Notice 98-5 and Notice 98-11, including the objection that the Notices inappropriately protected other nations’ tax revenue. Treasury withdrew the notices, and in the case of its withdrawal of the subpart F notice, provided generous transition relief based on the date regulations were finalized, which has not yet occurred.89

But this story need not read as the defeat of clumsy tax administrators at the hands of suave lobbyists. With respect to the issue of foreign tax credit abuse facilitated by check-the-box regulations, the government subsequently made significant progress by uncovering the problem of “foreign tax credit generator” transactions,90 enacting temporary anti-foreign-tax-credit generator regulations under Section 901 in 2006;91 proposing an anti-foreign-tax-credit splitter statute, Section 909, which was enacted in 2010;92 and developing a sophisticated litigation strategy that is working well, with three government wins so far.93 Vocal advocacy groups that object to MNC tax planning have also emerged over the last five years.94 The presence of

90. See Robert Goulder, Government Learned of Foreign Tax Credit Abuse Through International Information Exchanges, 2007 TNT 93-5, Doc 2007-11594 (reporting that information exchange with the UK tax authorities helped the IRS and Treasury discover foreign tax credit generator transactions).
92. See I.R.C. § 909 (2006); Education Jobs and Medicaid Assistance Act (signed into law August 10, 2010).
such groups at notice-and-comment proceedings might meaningfully change an environment otherwise dominated by MNC lobbyists.

C. Fewer Planning Options, Nontax Frictions

The current section 482 regulations give taxpayers numerous planning options and generally do not tether transfer pricing results to any high-friction non-tax reference point. Their complexity is not warranted by their capacity to deter taxpayer planning or by their ability to seek the truth about the correct assignment of items of income and deduction.95 And the government has broad discretion to change them. It should do so.

Revised transfer pricing and deduction sourcing rules should reduce taxpayer flexibility by giving taxpayers fewer planning options and incrementally incorporating formulary rules that use high-friction nontax reference points.96 An example of a proposed rule that follows this model is Ilan Benshalom’s proposal to assign IP ownership, as well as its related deductions and income, to the jurisdiction where the employees who produce the IP are based.97 Benshalom has also proposed a method for allocating income among affiliates of financial institutions based on tangible property and payroll.98

Other changes are also possible. As one example, existing cost-sharing regulations do not cover all U.S.-based overhead expenses, and other transfer pricing rules permit generous allocation of deductions to U.S. parents.99 Requiring the assignment of deductions to non-U.S. subsidiaries based on a high-friction metric such as profit or revenue might improve the result from the standpoint of the U.S. government, and could be accomplished through a regulatory change.100

support a level playing field on tax and we oppose loopholes and distortions in tax and regulation, and the abuses that flow from them.

95. See supra Part II.B (explaining the inadequacy of arm’s length and economic allegiance concepts for the task of dividing jurisdiction to tax).
96. See Schizer, supra note 84, at 1357–62; Weisbach, Line Drawing, supra note 67, at 1665-68 (considering the importance of behavioral distortions to the efficiency of tax rules).
97. See Benshalom, Unsourceable, supra note 32, at 682.
99. See Treas. Reg. § 1.482-7(d)(5) ex. 4 (2012) (requiring the sharing of time of “an executive officer who oversees a research facility” based on “the controlled participants’['] reasonable[ly] allocate[ed]”). The transfer-pricing regulations applicable to related party services are also relevant to the allocation of overhead costs. See Treas. Reg. § 1.482-9 (2012).
100. Deduction allocation is a well-known challenge in the event of adoption of a territorial system as well as under the existing system. See, e.g., Graetz & Oosterhuis, supra note 3, at 780-82 (discussing expense allocation issues).
D. What About the OECD?

A unilateral U.S. move to more formulaic transfer pricing rules would interact with transfer pricing norms mediated by international organizations and in particular by the OECD and the UN. Both the OECD, which generally represents developed nations’ interests in this area, and the UN, which often represents developing nations’ view, devote significant resources to transfer pricing. Although both organizations publicly support policy strategies that use the platform of the arm’s length standard, members of the UN have explicitly embraced specific formulaic approaches, including for the assignment of residual profit. Thus similar U.S. changes would arguably make the U.S. a transfer pricing pioneer within the OECD and would move U.S. transfer pricing policy closer to the policies of non-OECD countries such as Brazil, China, and India, even though the changes would also resemble formulaic approaches to other problems, such as interest expense apportionment, within the U.S. rules.

As argued below, despite the divergence of incremental unilateral formulaic approaches with the official OECD arm’s length party line, the U.S. adoption of such approaches presents an attractive risk/return profile. Incremental rule changes do not present the significant risks that would be presented by unilateral adoption of a global formulary apportionment standard. Rather, incremental rule changes would comport with increasing acceptance of the importance of incremental formulary methods to allocate residual profit as evidenced by between-the-lines suggestions in OECD work that such methods can play a useful role within the arm’s length standard, by some countries’ use of such methods, and by academics’ acceptance of their importance.

The proposals described here are less ambitious than global formulary apportionment proposals, although they share with such proposals the strategy of limiting taxpayer options by reference to high-friction nontax data points such as certain property, or payroll, or sales. Incremental transfer pricing reform is more feasible and less risky than sweeping adoption of a global formulary apportionment approach. Worldwide reform requires unrealistic assumptions about global cooperation and perhaps unacceptable inflexibility following the adoption of any global standard. Unilateral reform or worldwide reform with inconsistent tax rates and/or tax

102. See id. at 509–10.
103. See Morse, supra note 27, at 639–40.
bases also raises significant tax planning and economic factor manipulation risks due to firms’ incentive to minimize the identified factors in high-tax jurisdictions.104 Especially in an allocation formula that relies on very few factors, the factors would have high salience and material bottom-line impact on a firm’s tax bill.105 Finally, unilateral reform faces significant practical obstacles because of the difficulty of achieving congressional action and the possibility that a complete replacement of the arm’s length standard would violate U.S. treaty obligations.106

Incremental unilateral U.S. regulations that restricted taxpayers’ “freedom of contract” in transfer pricing,107 as proposed here, would differ from worldwide formulary apportionment. Such incremental reform would not formally depart from the arm’s length standard, but instead would redefine it. Incremental reform would not require global cooperation, would retain future flexibility with respect to U.S. policy options, and would raise less concern about factor manipulation.

However, the reaction of treaty and trading partners remains a valid consideration in the event of incremental changes to the U.S. transfer pricing rules for at least two reasons. First, the general goal of maintaining good foreign relations may discourage transfer pricing approaches that diverge from those adopted by treaty partners. Second, the “last in time” rule that provides that treaties and statutes have equal force of law, so that a later-enacted treaty trumps an earlier-enacted statute,108 does not apply to later-enacted regulations. Instead, regulations may be challenged not only by sovereign treaty partners, but also by affected taxpayers, who may claim that a later-enacted regulation is not consistent with the earlier understanding of the treaty partners when they entered into the treaty.109

105. See Morse, supra note 27, at 617 (citing Joann Martens-Weiner, Company Tax Reform in the European Union 33–34 (2006)).
107. Others also suggest incremental moves in this area. E.g., Avi-Yonah & Benshalom, supra note 5.
109. See, e.g., Xerox Corp. v. United States, 41 F.3d 647, 652 (Fed. Cir. 1994) (acknowledging doctrine of deference to treaty interpretation adopted by both treaty partners (citing Sumitomo Shoji Am., Inc. v. Avagliano, 457 U.S. 176, 185 (1982))); Xerox, 41 F.3d at 655–57 (refusing to decide foreign tax credit availability for a certain U.K. tax based on unilateral Treasury technical explanation of treaty and other unilateral guidance where evidence indicated that neither the Senate nor the U.K. government endorsed Treasury view); see also Michael S. Kirsch, The Limits of Administrative Guidance in the Interpretation of Tax Treaties, 87 Tex. L. Rev. 1063, 1084, 1098 (noting that, consistent with the Vienna Convention, “courts have looked to a wide range of
If treaty partner views continue to evolve and increasingly accept the incremental use of formulary methodology, such a taxpayer claim that an incremental formulary rule is not consistent with treaties will likely only work retrospectively. Consider the hard-fought *NatWest* case. This case culminated in the Federal Circuit’s 2008 holding that U.S. regulations that apportioned interest expense among affiliates according to a formula violated the U.S.–U.K. treaty because they “disregard[ed] interbranch transactions” and violated the parties’ understanding, at the time of the treaty’s execution, about allocating interest as if affiliates were “separate enterprises.”

The *NatWest* decision presumably helped the taxpayer in the case, which challenged U.S. interest allocations for the tax years 1981 to 1987. Perhaps it also helped taxpayers with contemporaneous challenges to the interest expense apportionment regulations. But the U.S. government stuck to its formulary approach for interest expense going forward. One commentator has suggested that “knowing that any subsequent treaties would incorporate the evolving views of the OECD, the Treasury probably kept the Regulation intact because it is acceptable under the more recent OECD commentary.”

Similarly, today evidence from OECD projects and perhaps also EU court decisions suggests that views on the correct interpretation of the arm’s length standard are evolving toward a greater acceptance of incremental formulary methodology.

The OECD, which has historically strongly endorsed the arm’s length standard, nevertheless has begun to acknowledge its limitations. For supplementary materials to illuminate the shared understanding of the United States and its treaty partners” and that “a joint technical explanation is likely to be given significant weight by U.S. courts.” Kirsch also argues that Article 3(2) as generally incorporated into most treaties “explicitly contemplate[s] that unilateral legal developments” may change the application of a treaty after it is signed, by providing that an undefined term “has the meaning that it has at [the] time [of application of the treaty] under the law of that State.” *Id.* at 1093.


112. *See Schön, supra* note 30, at 88–91 (discussing ECJ development of the idea of a “balanced allocation of taxing powers”).

113. *See, e.g., Transfer Pricing Guidelines, supra* note 28, at I-6 (“[T]he view of OECD Member countries continues to be that the arm’s length principle should govern the evaluation of
example, OECD base erosion and profit shifting (BEPS) materials acknowledge that “the international common principles drawn from national experiences” appear inadequate to the task of dividing tax jurisdiction in the modern globalized economy, and identifies the pressure on transfer pricing issues. More specifically, the OECD has developed a discussion draft relating to the transfer pricing treatment of intangibles. In this draft, it explains that “relevant functions, risks and costs” might not be “in alignment with contractual allocations” of returns from intangibles, in which case transfer pricing adjustments might address the disconnect. It also acknowledges the limitations of the arm’s length standard for transfers of intangibles, since related parties might undertake transactions in intangibles that unrelated parties “would not contemplate.”

Examples in the discussion draft reveal the OECD’s struggle to identify methods that make use of comparables recognizable within the arm’s length framework but still provide room for adjustments that increase the value of intangibles that produce more profit than expected or allocate residual profit to affiliates that bear more risk, as indicated by high-friction business decisions rather than intercompany contract. The methods are not explicitly formulaic, but they seem to move in that direction. For example, the possibility of increasing royalties paid for the use of an intangible is framed by the assumption “that there is evidence that independent enterprises would have insisted on protection in the form of . . . price adjustment[s].” The discussion draft is silent on the point of whether it anticipates rules that make that assumption, which would make the transfer pricing adjustment more formulaic; or rules that require an adjusting government to establish the basis for such an assumption, which would largely permit taxpayers to maintain their current freedom of contract with respect to setting such royalty rates.

In the EU, decisions by the European Court of Justice (ECJ) affect the transfer pricing debate. In the recent SGI case, the ECJ upheld Belgian
transfer pricing adjustments that, for example, imputed interest payments on an interest-free loan from a Belgian parent to its French subsidiary. The court relied on the idea of correcting an “artificial” arrangement in explaining its reasoning that the Belgian law was justified. Although the Belgian government won in SGI, the case could be read either to protect prices advocated and better documented by the taxpayer or to support government transfer pricing adjustments. Tax advisors who suggest that Belgian corporate affiliates can guard against any similar challenge by improving their transfer pricing documentation predictably contend that taxpayers can use the decision as a shield. But there is another way to look at the ECJ decision that reconciles it with developments in the OECD and elsewhere. Wolfgang Schön argues that on the facts of the case the ECJ endorsed the idea of arm’s length pricing as a tool that governments can use to address the problem of “artificial” pricing arrangements.

Aside from developments at the OECD and in the EU, individual member countries contributing to UN transfer pricing policy go further and explicitly apply formulaic methods to allocate profit, including residual profit. The UN includes the concept of arm’s length pricing in its model treaty and has reconfirmed support for the standard in a 2012 white paper. Yet the report acknowledges that several important countries interpret the standard to permit formulary methods of allocation, if they accept the standard at all. Brazil, for example, uses predetermined profit margins for imports and exports. China emphasizes that location-specific advantages provided by China should result in more allocation of profit to

120. Id.; see also Philip Baker, Transfer Pricing and Community Law: The SGI Case, 38 INTERTAX 194–96 (2010).
122. Schön, supra note 30, at 91–93.
125. See Comm. of Experts on Int’l Coop. in Tax Matters, supra note 124, § 10.1 (describing Brazil’s predetermined profit margin approach).
India contends that profit should follow risk, and rejects multinationals’ claim that their affiliates engaged in, for example, contract research and development are engaged in low-risk activities.\(^{127}\)

In addition to the growing consideration of incremental use of formulary methods in multinational white papers and government audit positions, important non-U.S. academics also stand in the corner of increased use of formulary methods. Schön, for example, contends that the ECJ’s characterization of the arm’s length standard as a tool to address transfer pricing abuse should permit formulary elements.\(^{128}\) Vann argues that “[p]rofit allocation can work through transactions but only if freedom of contract and the permitted transactions are constrained, or certain types of transactions are simply presumed which effectively allocate the residuum to the places where the firm is operating.”\(^{129}\)

Finally, it is possible that a particular incremental formulary change to U.S. transfer pricing regulations might not produce objections from treaty partners because the regulations might have an advantageous result for such treaty partners. For example, transfer pricing regulations that reference high-friction, non-tax data might assign profit to U.S. and treaty partners at the expense of low-tax holding company affiliates.\(^{130}\) U.S. tax administrators might explore the possibility of styling rules as safe harbors in part to reduce the chance of treaty-based challenges.\(^{131}\) And competent authority proceedings can help resolve conflicts that do arise.\(^{132}\)

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126. See id. § 10.2.3 (describing China’s treatment of location specific advantages).
127. See id. § 10.3.4 (describing India’s risk analysis).
128. See, e.g., Schön, supra note 30, at 97 (“[W]e have to face the fact that traditional transfer pricing control under the arm’s length standard is on the downturn in the European Union.”).
130. Treaty partners, like the U.S., face concerns about MNC tax planning. For example, several U.S.-parented MNCs, such as Google, Amazon, and Starbucks, have come under scrutiny in the U.K. because they are paying “little or no corporation tax” in that country despite large their operations. Mark Thompson, U.K. Targets Google, Amazon, and Starbucks on Taxes, CNNMONEY (Dec. 3, 2012, 8:24 AM), http://money.cnn.com/2012/12/03/news/uk-tax-avoidance/index.html. While testifying before a British parliamentary committee, Starbucks cited the fact that since starting business in Britain in 1998, it had only one profitable year there, “though it also admitted that its British business had made payments for coffee to a profitable Starbucks subsidiary in Switzerland and large royalty payments to another profitable subsidiary in the Netherlands for use of the brand and intellectual property.” Corporate Taxation: Wake up and Smell the Coffee, ECONOMIST, Dec. 15, 2012, at 66.
131. A safe harbor might put forth a pro-government formulary rule and permit taxpayers that follow the rule to receive greater assurances from the government about the certainty of the outcome. The government’s entry into an advance pricing agreement, for example, might be conditioned on taxpayer compliance with safe harbors. Although an analysis of the potential role of transfer pricing safe harbors falls outside the scope of this Article, such an analysis could include consideration of the impact of safe harbor-styled regulations on treaty challenges and consideration of the likely take-up of safe harbor offers by different taxpayers.
132. Mutual agreement proceedings are generally required by treaty. See, e.g., ORG. FOR ECON. COOP. & DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL art. 25 (2010); U.S.
IV. CONCLUSION

The second Obama Administration should seize a regulatory opportunity in the area of transfer pricing. It has broad discretion to change the transfer pricing regulations as they apply to corporate multinationals, and these regulations need changing, because they give far too much leeway to taxpayers and will continue to serve an important function in the division of international tax jurisdiction regardless of the fate of reform proposals. Xilinx and Veritas illustrate that taxpayers whose transfer pricing is challenged can successfully repel a government challenge by hiding behind arm’s length definitions in the government’s own regulations. Because the regs present the problem, changing the regs will provide the solution.

U.S. tax administrators should write revised transfer pricing rules that afford taxpayers less contracting freedom. They should incrementally add formulaic elements to rules and use high-friction, nontax reference points. Although the changes might appear to present a tension with longstanding treaty commitments to the arm’s length standard in transfer pricing, as articulated by OECD, a developing global consensus supports increased incremental use of formulary methods. Treaty partners might well accept and perhaps follow such changes, particularly if they resulted in the allocation of income away from low-tax affiliates and toward treaty partner jurisdictions as well as the U.S.


133. See discussion supra Part II.D.