Florida Tax Review

Volume 15 | Article 12

2023

Tax Base Erosion: Reformation of Section 482's Arm's Length Standard

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Wells, Bret and Lowell, Cym (2023) "Tax Base Erosion: Reformation of Section 482's Arm's Length Standard," *Florida Tax Review*: Vol. 15, Article 12.
Available at: https://scholarship.law.ufl.edu/ftr/vol15/iss1/12

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FLORIDA TAX REVIEW

Volume 15 | *2014* | *Number 10*

TAX BASE EROSION: REFORMATION OF SECTION 482'S ARM'S LENGTH STANDARD

by

Bret Wells[*]
Cym Lowell[**]

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I. INTRODUCTION

There is an important debate about fundamental tax reform looming,[1] and the problem of homeless income (HI)[2]—commonly referred to in the current round of debate as "base erosion and profit shifting" (BEPS)[3]—is at the center of the storm.[4] The media has incited the general public through llegations that multinational enterprises (MNEs), including many prominent MNEs,[5] have misreported their income, and that tax havens are a public

1. *See* NAT'L COMM'N ON FISCAL RESP. AND REFORM, THE MOMENT OF TRUTH: REPORT OF THE NATIONAL COMMISSION ON FISCAL RESPONSIBILITY AND REFORM, *reprinted at* 2010 TAX NOTES TODAY 231–35 (Dec. 1, 2010). *See also* President's Econ. Recovery Advisory Bd., TAX REFORM TASK FORCE RELEASES FINAL REPORT, *reprinted at*, 2010 TAX NOTES TODAY 167–50 (Aug. 30, 2010).

2. Source countries seek to retain taxing jurisdiction over routine profits through treaties and transfer pricing methods and cede taxing jurisdiction over residual profits to the taxpayer's country of residence. However, many countries have decided not to tax their resident corporations on extraterritorial income. Income that is not competitively taxed by the source country and which is given a concessionary or nonexistent tax rate by the resident country is referred to hereinafter in this Article as "homeless income." The income is "homeless" because it is not subject to competitive tax in any jurisdiction. The term "competitive tax" refers to currently prevailing levels of corporate taxation in developed countries.

3. "Base erosion and profit shifting" (BEPS) is the term currently used by the G8, G20G20, and OECD to describe the phenomenon. *See* Part II, *infra*. There are other terms commonly used to describe the phenomenon, including "double non-taxation." For the purpose of brevity, in this Article we will refer to the anxiety of governments concerning this problem hereinafter as the HI/BEPS problem.

4. *See* STAFF OF JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING, 111th Cong., (Comm. Print 2010), https://www.jct.gov/publications.html?func=startdown&id=3692. *See also* U.S. Treas. Dept, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES (2007), http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf. *See also* Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347 (2013) [hereinafter Graetz & Doud, *Technological Innovation*].

5. *See e.g.*, Jesse Drucker, *Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes*, BLOOMBERG TECHNOLOGY (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; *see also* David Kocieniewski, *But Nobody Pays That: At G.E. on Tax Day, Billions of Reasons to Smile*, NY TIMES (Mar. 25, 2011)

menace.[6] Not surprisingly, a wide range of policy formulations have been, and will be, put forward to address the HI/BEPS problem.[7] During the course of this debate, MNEs will argue that the current corporate taxation scheme of the U. S. is anti-competitive because it imposes the highest effective tax rate globally[8] and imposes extraterritorial tax costs on U.S.-owned MNEs (U.S.

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http://query.nytimes.com/gst/fullpage.html?res=9E07E5DE1131F936A15750C0A96 79D8B63; Margaret Heffernan, *Why Starbucks Tax Claims Don't Wash*, CBS MONEY WATCH (Nov. 13, 2012), http://www.cbsnews.com/8301-505125_162-57548821/why-starbucks-tax-claims-dont-wash/; Brendan Greeley, *Tim Cook, Taxes, and Avoiding the Right Thing*, BLOOMBERG BUSINESSWEEK (May 21, 2013), http://www.businessweek.com/articles/2013-05-21/tim-cook-taxes-and-avoiding-the the-right-thing; Washington Post Editorial Board, *Apple is Shifting its Tax Burden*, WASHINGTON POST (May 21, 2013), http://articles.washingtonpost.com/2013-05-21/opinions/39419357_1_tax-burden-corporate-tax-reform-u-s-tax-code.

6. Michael Durst frames the case in the following statement:

> I believe the primary societal danger posed by shifting income to tax havens is one of public perception, particularly as to confidence in the tax system and other public institutions. The media have covered the massive shifting of taxable income by U.S. multinationals to countries in which the companies might maintain nothing more than a mailbox. That situation obviously is artificial; it can be perceived by the public only as a result of manipulation of the law by politically empowered interests that seek to shift their shares of the federal and state tax burdens onto others. Whatever economic analysis one might use to justify the diversion of income to corporate pocketbooks located in tiny tax havens, the dominant image remains that of companies avoiding their income tax obligations through means unavailable to the ordinary citizen. That image is especially harmful in the aftermath of the financial collapse of 2008, which seems largely to have been caused by socially damaging business transactions conducted on a large scale in plain view of regulators, with no effective interference from government authorities. Corporate use of tax havens seems to confirm that the kind of failure of legislative and regulatory oversight represented by the mortgage-backed securities scandal is still with us. The appearance of a congruence of interest between financially motivated parties on the one hand and legislators and government regulators on the other to protect business practices that seem plainly cynical and contrary to the public interest is reason enough to eliminate opportunities to shift income to tax havens.

Michael C. Durst, *The Urgency—and Challenges—of International Reform*, 131 TAX NOTES 1277, 1277–78 (June 20, 2011).

7. *See* Graetz & Doud, *Technological Innovation*, *supra* note 4, at 392–434 (providing an overview of proposed policy responses).

8. *See America the Uncompetitive*, WALL STREET JOURNAL, (Aug. 15, 2008), http://online.wsj.com/article/SB121875570585042551.html.

MNEs) that are not imposed on their foreign-based competitors (non-U.S. MNEs).[9] As the parent company elects the residency of the MNEs, many countries have decided to forgo taxing extraterritorial income entirely, hoping to attract the corporate headquarters, research and development, and other highly remunerated jobs of the MNEs to their country.[10] Observing this trend, some countries have used the competitiveness argument to claim that the U.S. should avoid taxing international income entirely.[11] Although this conclusion may carry these implications too far, important scholarship does make the case that excessive residency-based taxation of U.S. MNEs risks contributing to the trend of acquisition of U.S. MNEs by non-U.S. MNEs or U.S. MNEs expatriating, actually or constructively, because of the tax advantages afforded to foreign ownership.[12] In response to this argument, at

9. *See* Michael S. Knoll, *The Corporate Income Tax and the Competitiveness of U.S. Industries*, 63 TAX L. REV. 771 (2010).

10. *See* Part IV *infra. See e.g.*, Pascal Faes, Philippe Malherbe, Henk Verstraete & Jacques Malherbe, *Business Operations in Belgium*, 953 TAX MGMT. PORT. (BNA) 3d. (2011) (setting forth special tax incentives to attract MNE headquarter functions to Belgium); *see also* John Ryan, Robert O'Shea & Aidan Fahy, *Business Operations in the Republic of Ireland*, 965 TAX MGMT. PORT. (BNA) 4th (2010) (providing an overview of the various holding company incentives, headquarter incentives, financing incentives, and intellectual property incentives for MNEs in Ireland); Peter Moons, *Business Operations in Luxembourg*, 971 TAX MGMT. PORT. (BNA) 3rd (2009) (setting forth various incentives to attract MNE headquarter functions to Luxembourg); Kees van Raad, *Business Operations in the Netherlands*, 973 TAX MGMT. PORT. (BNA) 3rd (2009) (setting forth a favorable tax regime for Netherlands-resident MNEs); Lian-Ee Teoh & Ching-Ling Seah, *Business Operations in Singapore*, 983 TAX MGMT. PORT. (BNA) 4th (2009) (setting forth various holding company, financing incentives, intellectual property incentives, and specific industry incentives to attract MNEs to operate in Singapore); Peter R. Altenburger, Joseph J. Czajkowski, Massimo G. Calderan & Werner Lederer, *Business Operations in Switzerland*, 986 TAX MGMT. PORT. (BNA) 3rd (2008), (setting forth holding company and financing incentives for attracting MNEs to Switzerland).

11. NATIONAL FOREIGN TRADE COUNCIL (NFTC), 1 THE NFTC FOREIGN INCOME PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY, iii (1999); NFTC, 2 THE NFTC FOREIGN INCOME PROJECT FOR THE 21ST CENTURY, 3 (2001).

12. *See* James R. Hines Jr., *Reconsidering the Taxation of Foreign Income*, 62 TAX L. REV. 269 (2009); *see also* Mihir Desai & James R. Hines, *Evaluating International Tax Reform*, 56 NAT'L TAX J. 487 (2003); Mihir Desai, *The Decentering of the Global Firm*, 32 The World Economy 1271 (2008); Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions*, 136 TAX NOTES 429 (July 23, 2012) [hereinafter Wells, *Inconvenient Truth*]; Bret Wells, *What Corporate Inversions Teach About International Tax Reform*, 127 TAX NOTES 1345 (June 21, 2010) [hereinafter Wells, *Corporate Inversions*]. One element of this advantage is that the value of a revenue stream is directly proportional to the effective tax rate to which such income is subject, regardless of the valuation method.

least six European nations have adopted so-called "patent box" regimes that provide concessionary tax rates to IP related income in an effort to attract high paying research and development jobs to their country.[13]

However, stating what the U.S. should not do (namely imposing excessive residency-based taxation that is out-of-step with its major trading partners—i.e., "anti-competitive taxation") does not answer the question of what the U.S. should do with respect to the HI/BEPS problem. Faced with the argument that any potential solution would be anti-competitive, the historical record indicates that Congress has repeatedly opted for an anti-competitive solution in lieu of doing nothing as a working majority of both political parties has historically found the HI/BEPS problem intolerable.[14]

Given the prospect that Congress may yet again propose an ad hoc solution creating a tax handicap for U.S. MNEs and leaving their non-U.S. MNE competitors alone to engage in HI/BEPS strategies, now is the time to build consensus for a solution to the HI/BEPS problem that will achieve the fiscal objectives of the U.S., which can be broadly framed as the following "tax policy objectives:"[15]

(1) Defend the U.S. tax base against the HI/BEPS problem in a manner consistent with domestic law and policy
(2) Ensure that any proposed solution to the HI/BEPS problem is consistent with U.S. Treaty Commitments
(3) Ensure that any proposed solution achieves "Competitive Neutrality" between U.S. MNEs and non-U.S. MNEs
(4) Ensure that any proposed solution is administrable and facilitates efficient tax collection.[16]

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13. *See* Graetz & Doud, *Technological Innovation*, *supra* note 4, at 362–75; *see also* Peter R. Merrill & James R. Shanahan Jr., et. al, *Is It Time for the United States to Consider the Patent Box?*, 134 TAX NOTES 1665 (Mar. 26, 2012) (discussing six patent box regimes implemented in Europe and posits the question whether the U.S. should adopt a similar regime). Policy issues concerning patent box regimes are beyond the scope of this Article, including whether such regimes institutionalize the HI/BEPS problem.

14. Bret Wells, *"Territorial" Tax Reform: Homeless Income is the Achilles Heel*, 12 HOUS. BUS. & TAX L.J. 1 (2012) [hereinafter Wells, *"Territorial" Tax Reform*].

15. There is a range of pending proposals to address the HI/BEPS problem, which are discussed and subsequently compared in terms of achievement of these policy objectives in Part IV, *infra*.

16. By "tax collection facilitation" we refer to the practical necessity that the mechanism determined to be the most attractive alternative addressing the HI/BEPS problem should also provide a means of facilitating the effective collection of the tax. As will be discussed *infra*, the critical issues relating to application of transfer pricing methodologies (under the arm's length standard or otherwise) are factual and thus inherently problematic in terms of self-determination of tax by

The objective of this Article is to enter this policy debate by posing an effective section 482-based solution to the HI/BEPS problem that achieves each of the enumerated fiscal policy objectives.[17] To formulate such a solution, the reasoning behind the HI/BEPS problem must be understood; thus, an analysis of the root cause of this phenomenon is set forth in Part III. In Part IV, we outline the various solutions to the HI/BEPS problem that have already been proposed. Finally, in Part V, we outline our proposed recommendation. It is our belief that policymakers, MNEs,[18] and Congress all have a shared interest in finding a mutually acceptable solution to the HI/BEPS problem, yet no solution has garnered broad support.

II. ANXIETY EXPRESSED BY THE G8, G20, EU, AND OECD

The HI/BEPS problem is a worldwide phenomenon. The United Kingdom has conducted high profile hearings on the techniques used to create homeless income out of profits originating in the U.K.[19] Australia recently released a thoughtful article indicating that such income-shifting is a major national concern.[20] Fiery Congressional hearings have been held on

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MNEs, examination by taxing authorities, resolution of tax controversies, and the ultimate collection of tax. *See* Part III, *infra* (referring to this issue as the "factual determination challenge").

17. The basis for this conclusion is discussed in detail in Part IV, *infra*.

18. MNEs should seek such a solution to the HI/BEPS problem that is competitively neutral because history indicates they are at risk of exposure to an inferior solution that will be anti-competitive. The advantages created by traditional transfer pricing and treaty principles are unsustainable in the current political environment for the reasons discussed in this Article. If so, the benefitting MNEs would be inclined to support solutions that are not anti-competitive to their interests in application. MNEs that stand aloof refusing to support any solution risk the prospect of allowing a consensus to form with respect to more punitive and anti-competitive solutions. It is time for policy-makers, MNEs, and Congress to find a mutually acceptable solution that preserves competitive neutrality.

19. Julie Martin, *Google and Possibly E&Y to Testify Again on U.K. Tax Avoidance*, 2013 WORLDWIDE TAX DAILY 85-2, (May 2, 2013); Julie Martin *U.K. Puts Executives in Hot Seat Over Transfer Pricing Practices* 2012 WORLDWIDE TAX DAILY 221-4, (Nov. 15, 2012) (discussing how CEOs of Google, Starbucks, and Amazon were called to testify to the Public Accounts Committee in the U.K.); U.K. HOUSE OF COMMONS COMMITTEE OF PUBLIC ACCOUNTS, HM REVENUE & CUSTOMS: ANNUAL REPORT AND ACCOUNTS 2011-12, NINETEENTH REPORT OF SESSION 2012-13 (U.K.), *reprinted at* 2012 WORLDWIDE TAX DAILY 233-32, (Nov. 28, 2012).

20. *See* David Bradbury, Assistant Treasurer of Australia, Speech to Taxation Institute of Australia's 28th National Convention: Stateless Income: A Threat to National Sovereignty (Mar. 15, 2013) (transcript at http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=speeches/2013/003.htm&pageID=005&min=djba&Year=&Doc Type=) (discussing the need for Australia to adopt measures

the tax planning practices of notable U.S. MNEs.[21] The U.S. has been continually frustrated by the phenomenon for over 50 years.[22] Significant pronouncements have been made by G20 member states on the need to coordinate efforts to deal with the HI/BEPS problem.[23] The G8 has reiterated

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protecting itself against base erosion); *see also* Australian Government of the Treasury, *Implications of the Modern Global Economy for the Taxation of Multinational Enterprises* (May 3, 2013), http://www.treasury.gov.au/~/media/Treasury/Consultations%20and%20Reviews/2013/Taxation%20of%20Multinational%20Enterprises/Key%20Documents/PDF/IssuesPaper.ashx.

21. Such tax planning allegedly permits some U.S. MNEs to earn almost half of their profits in low-tax subsidiaries located in Ireland and Singapore. *See Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft & Hewlett Packard): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 112th Cong. 2 (2012), http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code [hereinafter *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*] (statement of Sen. Carl Levin, Chairman, Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs). Senator Levin alleged that one U.S. MNE's international tax planning using grandfathered cost sharing agreements and check-the-box structures allowed it to avoid paying $9 billion of U.S. tax in 2012 alone. *See Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 112th Cong. 6 (2013), http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2 [hereinafter *Offshore Profit Shifting Hearing (Apple Inc.)*] (statement of Sen. Levin).

22. The Staff of the Joint Committee on Taxation also set forth six case studies based on actual, anonymous MNEs demonstrating how profits are shifted to low tax jurisdictions by MNEs. *See* STAFF OF JOINT COMM. ON TAXATION, *supra* note 4. *See also* Bret Wells & Cym Lowell, *Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin*, 65 TAX L. REV. 535 (2012) (providing a historical development of the HI/BEPS problem, its origins, and the repeated failed attempts by the U.S. to attack this problem) [hereinafter Wells & Lowell, *Tax Base Erosion and Homeless Income*].

23. *See* OECD, *Communique of Meeting of Finance Ministers and Central Bank Governors*, 2013 WORLDWIDE TAX DAILY 77-26, Tax Doc. 2013-9745 (Apr. 18-19, 2013) (stating that the G20G20 would "welcome the progress made in the development of an action plan on tax base erosion and profit shifting"). *Id. See also* Wolfgang Schauble & George Osborne, Joint Statement by the United Kingdom and Germany (Nov. 5, 2012) (transcript available at https://www.gov.uk/government/speeches/statement-by-the-chancellor-of-the-exchequer-rt-hon-george-osbore-mp-britain-germany-call-for-international-action-to-strengthen-tax-standards) (urging G20 to adopt international tax standards to address tax base erosion by multinationals).

the importance of finding a solution to the HI/BEPS problem.[24] The EU has launched a new initiative to create "peer pressure" among EU member states to address tax avoidance strategies (a.k.a. strategies designed to create the HI/BEPS problem).[25]

In response to direction from the G8 and G20, the Organization for Economic Co-operation and Development (OECD) has issued a report discussing the HI/BEPS problem but stopped short of making definitive policy recommendations.[26] A group of tax administrators from 45 member states has agreed to work on efforts to defend against inappropriate tax base erosion strategies.[27] A working group of developing nations also commenced a cooperative effort to formulate policy responses appropriate for emerging market economies.[28] The United Nations has engaged in an ongoing effort to

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24. *See* Rick Mitchell, *Tax Evasion: G8 Leaders Make New Pledge to Fight Evasion, Profit Shifting, and Money Laundering*, 118 DAILY TAX REP. (BNA), June 19, 2013, at GG-1.

25. *See* European Commission, *Recommendation on Aggressive Tax Planning*, C(2012)8806 (Dec. 6, 2012), http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8806_en.pdf; *see also* European Commission, *Commission Recommendation Regarding Measures Intended to Encourage Third Countries to Apply Minimum Standards of Good Governance in Tax Matters*, C(2012)8805 (Dec. 6, 2012), http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/c_2012_8805_en.pdf (stating that member states must further improve its work on harmful tax competition and reinvigorate the work on business taxation and announcing that the EU Commission would set up new, active monitoring tools and scoreboards to maintain momentum on fighting tax evasion and avoidance).

26. *See* OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING (2013), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1 [hereinafter OECD, ADDRESSING BEPS]. On July 17, 2013, the OECD released its "Action Plan." *See* OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013), http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/action-plan-on-base-erosion-and-profit-shifting_9789264202719-en [hereinafter OECD, ACTION PLAN]. *See* Part IV, *infra*, for a brief discussion of the elements of the Action Plan, and Part V, *infra*, for a brief comment on how this Article's section 482-oriented proposal would achieve virtually every objective of the Action Plan that relates to transfer pricing.

27. OECD, *Final Communique of the OECD Forum of Tax Administration*, 2013 WORLDWIDE TAX DAILY 97-32, Tax Doc. 2013-12154 (May 16-17, 2013).

28. BRICS Heads of Revenue, *Communiqué of BRICS Heads of Revenue Meeting Issued in New Delhi on 18th January, 2013*, GOVERNMENT OF INDIA PRESS INFORMATION BUREAU (Jan. 18, 2013), http://pib.nic.in/newsite/erelease.aspx?relid=91684 (announcing formation of working groups to address tax base erosion by MNEs).

update its own transfer pricing manual to address the HI/BEPS problem.[29] Most recently, in July 2013, the OECD has issued its Action Plan for addressing the HI/BEPS problem.[30]

Accordingly, it is fair to say that the HI/BEPS problem represents a dominant policy issue for the international community, and the current furor is not likely to subside until an effective solution is formulated. In a time of stressed fiscal budgets, the existence of large amounts of MNE income escaping any taxation puts enormous pressure on countries to find a policy response. Formulating a response that achieves the objectives of all interested parties will be the coveted holy grail of international tax policy for this generation. A global consensus is demanding that a solution to the HI/BEPS problem be found. The authors of this Article believe that it can be found in what many perceive as an unlikely place—within the arm's length standard itself.

III. BEHAVIOR DICTATED BY MODEL TREATIES AND ONE-SIDED TRANSFER PRICING METHODOLOGIES

A. *Predicate Challenges to the Arm's Length Standard*

Before analyzing where reform is needed within section 482, it is important to lay a foundation for such a discussion. In this regard, it must be admitted that the arm's length standard (as historically applied under section 482)[31] has suffered withering attack and criticism. A significant chorus of respected international tax scholars and former Treasury officials have concluded that the arm's length standard is simply unworkable and thus

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29. *See* U.N. Dep't of Econ. & Soc. Affairs, *Practical Manual on Transfer Pricing for Developing Nations*, ST/ESA/347 (2013), www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

30. *See* Part IV, *infra*.

31. The arm's length standard has been the global standard since the 1920s when it supplanted profit-split methodologies. *See* Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX. REV. 89 (1995) [hereinafter Avi-Yonah, *Rise and Fall*] (detailing an excellent historic development of the arm's length standard as understood in section 482). *See also* Harlow Higinbotham, David Asper, Philip Stoffregen, and Raymond Wexler, *Effective Application of the Section 482 Transfer Pricing Regulations*, 42 TAX L. REV. 293, 330–38 (1987) [hereinafter Higinbotham, et. al, *Effective Application*]; Note, *Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1215 (1976); Stanley Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 666–69 (Feb. 17, 1986) [hereinafter Langbein, *Unitary Method*]; Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 558–61, 577–81, 584–94.

concluded that any proposed solutions to the HI/BEPS problem must come from outside of the arm's length standard.[32]

The mere existence of the HI/BEPS problem itself could be viewed as providing sufficient evidence for a prima facie case that the arm's length standard is deficient. MNEs argue that their tax planning and use of low-tax foreign subsidiaries "comply with U.S. and foreign tax laws."[33] Legislators and scholars alike respond that the existence of the HI/BEPS problem provides compelling evidence that the arm's length standard does not and cannot defend against inappropriate income shifting to tax havens.[34] Faced

32. *See, e.g.*, Graetz & Doud, *Technological Innovation*, *supra* note 4, at 413–34 (2013); George Mundstock, *The Borders of E.U. Tax Policy and U.S. Competitiveness*, 66 U. MIAMI L. REV. 737 (2012); Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 510–23 (2009) [hereinafter Avi-Yonah, Clausing & Durst, *Business Profits for Tax Purposes*]. The arbitrariness of pre-set formula apportionment regimes has been vigorously asserted. The effect of such defenses has not been to rehabilitate the wisdom of the arm's length standard so much as it has been stated that formula apportionment itself is no panacea either. *See* CHARLES E. MCLURE, JR., *The State Corporate Income Tax: Lambs in Wolves' Clothing*, THE ECONOMICS OF TAXATION 327, 335–36, (Henry J. Aaron & Michael J. Boskin eds., 1980), http://www.treasury.gov/resource-center/tax-policy/tax-analysis/Documents/ota25.pdf; James R. Hines, Jr., *Income Misattribution Under Formula Apportionment*, 54 EUR. ECON. REV. 108 (2010); Rosanne Altshuler & Harry Grubert, *Formula Apportionment: Is It Better than the Current System and Are There Better Alternatives?* 63 NAT'L TAX J. 1145 (2010); Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 599 (2010).

33. Statement of William J. Sample, Vice President of Worldwide Tax for Microsoft Corporation, *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard), supra* note 21, at 30, http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code; *see also* Testimony of Tim Cook, CEO of Apple, Inc., *Offshore Profit Shifting Hearing (Apple), supra* note 21, at 30 (stating that its cost sharing agreement and tax practices complies fully with all applicable Treasury regulations).

34. *See, e.g.* Press Release, Senator Carl Levin, Chairman of the Senate Permanent Subcommittee on Investigations (May 20, 2013), http://www.levin.senate.gov/newsroom/press/release/subcommittee-to-examine-offshore-profit-shifting-and-tax-avoidance-by-apple-inc- (stating that "[a U.S. MNE has] sought the Holy Grail of tax avoidance. It has created offshore entities holding tens of billions of dollars, while claiming to be tax resident nowhere. We intend to highlight that gimmick and other . . . offshore tax avoidance tactics so that American working families who pay their share of taxes understand how offshore tax loopholes raise their tax burden, add to the federal deficit and ought to be closed."). *Id.* Statement of Senator Levin, *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*, *supra* note 21, at 2 (in the context of focusing on the tax planning of Microsoft, Senator Levin asserted that [another U.S. MNE] conducted 85 percent of its research

with a loss of faith in section 482 and in an effort to protect the U.S. tax base from tax base erosion strategies of MNEs, Congress has repeatedly adopted backstop regimes in the context of both outbound transactions, such as the subpart F regime and section 367(d), and inbound transactions, such as sections 163(j) and 897. The far flung search for the "holy grail" of base protection has led to proposals repealing the deferral privilege entirely with respect to the earnings of foreign subsidiaries[35] and innovative alternative minimum tax regimes.[36]

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and development activities in the United States but reported $8 billion in profits in its offshore subsidiaries in Ireland and Singapore and saved another $4.5 billion in taxes by selling non-U.S. intellectual property rights to a Puerto Rican subsidiary); Testimony of Stephen E. Shay, *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*, *supra* note 21, at 10–12 (discussing the policy implications arising from its tax planning); Testimony of Reuven Avi-Yonah, *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*, *supra* note 21, at 12–14.

35. *See* Jeffrey M. Kadet, *U.S. Tax Reform: Full-Inclusion Over Territorial System Compelling*, 139 TAX NOTES 295 (Apr. 15, 2012); Jasper L. Cummings, Jr., *Consolidating Foreign Affiliates*, 11 FLA. TAX REV. 143, 195–96 (2011); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 31 TAX NOTES INT'L 1177, 1207 (Sept. 29, 2003); Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax On Foreign Source Income*, 52 SMU L. REV. 455, 458 (1999); *see, e.g.*, Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219, 224 (Jan. 13, 1997); Asim Bhansali, *Globalizing Consolidated Taxation of United States Multinationals*, 74 TEX. L. REV. 1401, 1422 (1996); Daniel J. Frisch, *The Economics of International Tax Policy: Some Old and New Approaches*, 47 TAX NOTES 581 (Apr. 30, 1990); Jane G. Gravelle, *Foreign Tax Provisions of the American Jobs Act of 1996*, 72 TAX NOTES 1165 (Aug. 26, 1996); Robert A. Green, *The Future of Source-Based Taxation of the Income of Multinational Enterprises*, 79 CORNELL L. REV. 18, 75 (1993); John McDonald, *Anti-Deferral Deferred: A Proposal for the Reform of International Tax Law*, 16 NW. J. INT'L L. & BUS. 248, 281 (1995); Peter R. Merrill & Carol Dunahoo, *'Runaway Plant' Legislation: Rhetoric and Reality*, 72 TAX NOTES 221, 221 (July 8, 1996); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042, 1061 (1996); Joseph Isenbergh, *Perspectives on the Deferral of U.S. Taxation of the Earnings of Foreign Corporations*, 66 TAXES 1062, 1063 (1988); Lee Sheppard, *Last Corporate Taxpayer Out the Door, Please Turn Out the Lights*, 82 TAX NOTES 941, 944 (Feb. 15, 1999). *But see*, James R. Hines, Jr., *The Case Against Deferral: A Deferential Reconsideration*, 52 NAT'L TAX J. 385, 401–02 (1999).

36. *See* U.S. TREAS. DEP'T, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2014 REVENUE PROPOSALS 49 (2013), http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf (proposing to expand subpart F to include "excess intangible income"); Calvin Johnson, *Taxing GE and Other Masters of the Universe*, 132 TAX NOTES 175 (July 11, 2011) (proposing a minimum tax based on market

Viewed in light of this record, any effort to propose a section 482-based solution to the HI/BEPS problem necessarily faces an uphill climb. First, the credibility of section 482 as a means to protect the U.S. tax base must be rehabilitated in the minds of scholars and policymakers who have witnessed the enormous income-shifting opportunities afforded MNEs under the current law. A reasoned explanation must be given as to why the arm's length standard has previously been ineffective and why a properly designed reformation of section 482 would protect the U.S. tax base. Only when such a foundation proves that the flaws in section 482 are not fatal and capable of reformation can a section 482-based solution to the HI/BEPS problem be accepted.[37]

However, with the above-mentioned reservations in mind, it should also be noted that a section 482-based solution is preferable because it would create the least conflict with our existing tax treaty partners (many of whom endorse the arm's length standard).[38] Consequently, a section 482-based solution minimizes the risk of international double taxation, whereas the other policy responses set forth in Part IV are unilateral acts that create a significant risk of fostering an anti-competitive tax environment.[39] Thus, even though the burden of proof necessary to rehabilitate the credibility of section 482 and the arm's length standard may be high, the attractiveness of finding an effective section 482-based reform proposal is correspondingly high as well.

B. Transfer Pricing Preference for One-Sided Methodologies

With the above foundational challenge in mind, it is appropriate to examine section 482 and explore why it has been ineffective in the context of the HI/BEPS problem. We start by understanding how section 482 has traditionally been applied in the MNE context. In this regard, a related party transaction, by definition, involves at least two controlled taxpayers. The fundamental transfer pricing question in that context is how the combined

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capitalization of a MNE); Susan Morse, *A Corporate Offshore Profits Transition Tax*, 91 N.C. L. REV. 549 (2013) (proposing a five percent to ten percent surtax on unrepatriated foreign subsidiary earnings in the event the U.S. were to adopt a territorial tax system). A comparison of these proposals and the solution offered herein is set forth in Part IV, *infra*.

37. Susan M. Morse, *Tax Advice for the Second Obama Administration, The Transfer Pricing Regs Need a Good Edit*, 40 PEPP. L. REV. 1415 (2013) (stating that solutions to the HI/BEPS problem can be found in reforming the transfer pricing rules and advocating that the transfer pricing rules should afford taxpayers less contracting freedom and add formulaic elements and use high friction, non-tax reference points).

38. *See* tax policy objective (2) in Part I, *supra*.

39. *See* tax policy objective (3) in Part I, *supra*.

profits should be allocated among the related parties.[40] For this purpose, the section 482 regulations endorse the usage of either One-Sided Transfer Pricing Methodologies[41] or Two-Sided Transfer Pricing Methodologies[42] without prioritization.[43]

The premise of this Article is that the failure of section 482 to require the usage of Two-Sided Transfer Pricing Methodologies in the MNE context is a fundamental mistake that makes section 482 unworkable for the reasons explained *infra*. To make section 482 effective at preventing the HI/BEPS problem, all transactions where residual profits exist within the MNE group should be allocated among affiliates using a two-sided transfer pricing methodology, either as the primary transfer pricing method or as a confirmation for another method.[44] Failure to use a two-sided transfer pricing

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40. *See* Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79, 87–94 (2008) (noting the incompatibility of arm's length pricing to handle residual profits of a vertically integrated firm); *see also* Richard J. Vann, *Reflections on Business Profits and the Arm's Length Principle,* THE TAXATION OF BUSINESS PROFITS UNDER TAX TREATIES 133, 140–41 (Brian J. Arnold, Jacques Sasseville & Eric M. Zolt, eds., 2003).

41. One-Sided Transfer Pricing Methodologies refer to the traditional transactional tests of comparable uncontrolled price, resale price, cost plus, and comparable profits methods. These methods are "one-sided" in the sense that they apply the arm's length standard by making one party the "tested party" that is entitled to only a "routine profit." Under the regulations, there is no strict hierarchy of methods. Instead, the regulations prescribe a more flexible "best method" approach. The best method is the method that provides the most reliable measure of an arm's length result. Reg. § 1.482-1(c)(1). In applying the "best method" rule, the parties should use the information that is considered the most reliable. Reg. § 1.482-1(c)(2). The impact of testing only one party and not both parties is that the untested party is entitled to all residual profits by default.

42. Two-Sided Transfer Pricing Methodologies refer to profit split or residual profit split methodologies. These methods are "two-sided" in the sense that both affiliates are considered "tested parties" under these transfer pricing methodologies for purposes of determining how to allocate the combined income of the MNE whereas the traditional transactional transfer pricing methods represent One-Sided Transfer Pricing Methodologies in that the transaction transfer pricing methods use only one affiliate as the "tested party." The U.S. resisted the use of profit split methodologies for many years. The evolution of how profit split and residual profit split methodologies became an accepted part of the section 482 landscape has been chronicled elsewhere. *See* Avi-Yonah, *Rise and Fall*, *supra* note 31, at 112–32; Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 577–94; Higinbotham et. al., *Effective Application, supra* note 31, at 330–38; Langbein, *Unitary Method*, *supra* note 31, at 666–69.

43. *See* Reg. § 1.482-1(c)(1).

44. As discussed *infra*, this is the approach courts have taken in resolving the most difficult cases. It is also the normal process of mutual agreement or

methodology in all related party MNE transactions is what provides the fertile ground for creating the HI/BEPS problem.[45]

1. *One-Sided Transfer Pricing Methodology*

A one-sided transfer pricing methodology isolates one or more (but not all) of the related party entities and identifies this sub-group of affiliates as "tested parties"[46] leaving aside one (or more than one) affiliate as an "untested party." The reasoning is that if the tested party's share of the combined income meets the arm's length standard, then as a matter of mathematical logic the untested party's income by inference must also meet this standard even though it remains untested.[47] Thus, the impact of using a one-sided transfer pricing methodology is that the "tested party" is allocated a routine profit based on an analysis of what unrelated companies would routinely earn for their identified functions while the untested party keeps all of the residual income (i.e., the combined income less the routine profits allocated to the tested party).

A one-sided transfer pricing methodology may work well when there are only routine profits to be divided among MNE affiliates. However, when residual profits exist, a one-sided transfer pricing methodology is incapable of explaining why residual profits should reside with any particular entity and simply assumes that the untested party should be the recipient without further explanation. This is the essential paradigm that allows the HI/BEPS problem to exist. One-Sided Transfer Pricing Methodologies simply accept this outcome.[48]

One-Sided Transfer Pricing Methodologies consequently put enormous emphasis on the foundational question of which party should be the "tested party" and which party should not be tested, as it is only the

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competent authority transfer pricing case resolution between tax treaty countries. The results of the cases are public, while those of a competent authority are not. Nonetheless, when the former is compared to statistics relating to the latter, the resultant framework is instructive as a means of rehabilitating section 482.

45. The original formulation of the arm's length standard during the period of 1920-1923 adopted just such an approach, which was rejected in 1926 by the League of Nations. The transfer pricing rules have remained essentially the same in the interim. *See* Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 545–602.

46. *See* Reg. § 1.482-5(b)(1).

47. If an MNE's combined income ("C") is composed of the income of Affiliate A ("A") plus the income of Affiliate B ("B"), and if Affiliate A's income is tested and meets the arm's length standard, then we can assume that Affiliate B is entitled to receive the difference of "C" minus "A," which should equal "B".

48. *See* Higinbotham et. al., *Effective Application, supra* note 31, at 330–38; Langbein, *Unitary Method, supra* note 31, at 666–69.

"tested party" whose profits are benchmarked. The section 482 regulations answer this crucial, dispositive question by stating that the "tested party" should be the controlled party whose operating profit can be verified using the most reliable data and requires the fewest and most reliable adjustments.[49] Therefore, the "tested party" should be the least complex of the controlled taxpayers and should be able to be compared with uncontrolled comparable taxpayers.[50] Once agreement is reached on the risk-function responsibilities between the pertinent affiliates and which party should be the "tested party," the profit allocations are no longer controversial because the routine profits attributable to routine functions are common knowledge among those experienced in transfer pricing matters—both for the taxpayer and the taxing authority.

However, what is controversial, and what has made a decided impact on the outcome of the section 482 transfer pricing debates, is the foundational question of which MNE affiliate is framed as the complex "untested party" and which MNE affiliate is framed as the straightforward "tested party." In a potential base erosion context where there is more than routine income on a combined basis, MNEs will understandably desire to frame their U.S. affiliate as the straightforward "tested party" entitled to only a routine profit margin and frame their low-taxed foreign affiliate as the complex "untested party" entitled to all the residual profits without further explanation.

It is with respect to this critical dispositive framing game where One-Sided Transfer Pricing Methodologies provide MNEs enormous value through proactive tax planning. In this regard, an MNE can designate one or more affiliates of its group to be the risk taker with respect to a particular trading pattern.[51] The risk taker is often located in a low-tax jurisdiction and given the "complex profit picture" through intercompany agreements executed among the MNE affiliates. The U.S. affiliate[52] assumes the role of non-risk taker providing only routine functions.[53]

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49. Reg. § 1.482-5(b)(2)(i).

50. *Id. See also* Reg. § 1.482-5(e), Ex. 4. In order to determine which transfer pricing method is most reliable, the regulations articulates the best method rule that looks to the degree of comparability of the tested party with that of the uncontrolled taxpayer. Reg. § 1.482-5(c)(2)(i).

51. *See* CYM LOWELL, PETER BRIGER & MARK MARTIN, U.S. INTERNATIONAL TRANSFER PRICING, ¶ 4.04[4][c][i] (Warren Gorham & Lamont/Thomson Reuters eds., 2013) [hereinafter LOWELL, BRIGER & MARTIN, U.S. INTERNATIONAL TRANSFER PRICING].

52. For purposes of convenience, this Article refers to tax planning undertaken by a U.S. MNEs. The same methodologies are available to non-U.S. MNEs.

53. Base erosion can occur through related party payments of rents, royalties, interest, service fees, and by related party purchase and sale of goods.

If the U.S. affiliate provides "straightforward" service-related functions, then it would be allocated a routine profit (typically using the comparable profits or cost plus methods).[54] If the U.S. affiliate were to provide "straightforward" manufacturing-related activities, then it would be allocated a routine profit for those activities as well (typically using a resale profit methodology). To make such a planning structure effective, all non-routine intangibles must be owned by the offshore affiliate (via qualified cost sharing agreements,[55] developed by the foreign affiliate itself with its own personnel, or acquired through some other form of transfer or contribution).[56]

Again, the desired transfer pricing result is to frame the non-risk taking U.S. affiliate as the "tested party," whereas the risk taking tax haven affiliate is factually presented as "complex" and thus entitled to be framed as the "untested party" receiving all residual profits without explanation. Thus, through proactive upfront tax planning and the usage of a one-sided transfer pricing methodology, the groundwork is in place to create significant amounts of homeless income in tax haven jurisdictions that is blessed by the section 482 regulations and need not be explained to anyone.[57]

The result of this framing game lying at the heart of One-Sided Transfer Pricing Methodologies is an ad hoc "all or nothing" scorecard with respect to the holdings of cases involving the IRS's efforts to tax residual

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Reforms that attack a particular form of related party payments but leave One-Sided Transfer Pricing Methodologies in place are ineffective because these reforms motivate taxpayers to simply use the remaining base erosion techniques to strip profits. Although the mechanics of base erosion are important to consider, they have been fully considered by the authors elsewhere and are outside the scope of this Article. *See* Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 540–45 (discussing the mechanics of base erosion); Wells, *"Territorial" Tax Reform*, *supra* note 14, at 6–11. These base erosion techniques have also been studied and well documented by others. *See e.g.*, JOINT COMM. ON TAXATION, *supra* note 4; *see also* U.S. TREAS. DEP'T, REP. TO THE CONG. ON EARNINGS STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES (2007), http://www.treasury.gov/resource-center/tax-policy/Documents/ajca2007.pdf.

54. *See* LOWELL, BRIGER & MARTIN, U.S. INTERNATIONAL TRANSFER PRICING, *supra* note 51, at ¶¶ 4.09, 6.02[3][d].

55. *See* Reg. § 1.482-7(b).

56. *See* LOWELL, BRIGER & MARTIN, U.S. INTERNATIONAL TRANSFER PRICING, *supra* note 51, at ¶¶ 5.04–5.09.

57. The prevalence of One-Sided Transfer Pricing Methodologies is reflected in the annual statistics of the IRS Advance Pricing Agreement Program [hereinafter "the Program"]. For the most recent year (2012), the Program reported that the vast bulk of its cases involved routine service, distribution, or manufacturing pricing matters, with 70 percent involving distribution or related routine functions. Announcement 2013-17, 2013-16 I.R.B. 911, Part III. Only a "small percentage of the tested parties performed more complex or high value functions." *Id.* Similarly, the primary transfer pricing methods were one-sided methods. *Id.*

profits of an MNE. The transfer pricing dispute in cases utilizing One-Sided Transfer Pricing Methodologies is not over the routine profit; it is typically over the residual profits.

For example, in *U.S. Steel Corp. v. Commissioner*,[58] a location advantage for mining iron ore in Venezuela created a residual profit to the MNE group. U.S. Steel (USS) formed Orinoco Mining Company (Orinoco), a wholly owned Delaware subsidiary, to own and exploit new Venezuelan mines. Initially, the Orinoco ore was transported to the United States in chartered vessels owned by independent companies, but in 1953 USS incorporated another wholly owned subsidiary, Navios, Inc. (Navios), in Liberia, with its principal place of business in Nassau, Bahamas. Navios was organized for the purpose of chartering carriers transporting iron ore mined by Orinoco. Accordingly, Navios entered into shipping agreements with third parties. The prices charged by Navios to other domestic steel companies during the relevant period were the same as those charged to USS. The prices were structured in such a manner so that the delivered cost of iron ore to USS would not be below the prices USS was charged for ore from unrelated U.S. mines. The consequence of this business restructuring exercise was that Navios kept all the residual profits from the Venezuelan location advantage while USS and Orinoco earned only a routine profit for their various functions.

The Tax Court agreed with the IRS that Navios should be the tested party and allocated a routine profit, and any residual profit should belong to USS. To determine the appropriate arm's length charter rate that Navios should charge in order to provide Navios with a routine shipping profit, the Tax Court extrapolated hypothetical shipping rates for 1957 through 1960 from what certain independent shippers had charged in their 1954 contracts with USS, adding adjustments to account for increased cost, risk, and profit. As a check on the accuracy of this historical approach, and to determine the amount of allocation, the Tax Court also constructed hypothetical rates based on estimates of what Navios's costs had been during the taxable years in question, adjusting these estimates to allow for risk and profit and then chose the method that, for each taxable year, would result in the lowest reallocation in favor of the IRS. According to the Tax Court, all excess profits above this derived profit belonged to the U.S. affiliate.

However, the decision of the Tax Court was reversed on appeal. The Second Circuit agreed with the taxpayer's assertion that the "tested party" should be USS and not Navios. The court noted that the prices charged by Navios for delivered ore to USS were the same prices as those charged by third parties. The Second Circuit recognized that allowing Navios to keep all residual profits without explanation allowed Navios to effectively become an

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58. 36 T.C.M. (CCH) 586, T.C.M. (P-H) ¶ 77,140 (1977), *rev'd*, 617 F.2d 942 (2d Cir. 1980).

offshore tax shelter.[59] But standing alone, this fact was insufficient to justify a reallocation of income under section 482, as Navios also "served a major business purpose unrelated to tax-shifting: allowing [USS] to reap the cost savings of using a non-United States-flag fleet."[60] The Second Circuit concluded that USS had met the standards of section 482 when it treated USS as a tested party and utilized a one-sided transfer pricing methodology to provide USS with a routine profit, stating as follows:

> We think it is clear that if a taxpayer can show that the price he paid or was charged for a service is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties," it has earned the right . . . to be free from a [section] 482 reallocation despite other evidence tending to show that its activities have resulted in a shifting of tax liability among controlled corporations. Where, as in this case, the taxpayer offers evidence that the same amount was actually charged for the same service in transactions with independent buyers, the question resolves itself into an evaluation of whether or not the circumstances of the sales to independent buyers are "similar" enough to sales to the controlling corporation under the circumstances, "considering all relevant facts." In our view, "considering all the relevant facts," the evidence was sufficient to show similar enough transactions with independent buyers to establish that the price [USS] paid Navios [for iron ore] was an arm's length price.[61]

However, the Second Circuit's opinion ignores the fundamental problem—residual profits existed within the MNE group that could not be explained by the routine functions performed by any single affiliate, including Navios. Which entity deserved those residual profits? By making USS the tested party, all residual profits were left inexplicably with the untested party, Navios.

The holding in *U.S. Steel* was widely understood as having endorsed a significant tax planning opportunity.[62] The *U.S. Steel* case is (in)famous

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59. United States Steel Corp. v. Commissioner, 617 F.2d 942, 945 (2d Cir. 1980).

60. *Id.*

61. *Id.* at 947. The essence of the finding is a factual determination challenge. *See supra* note 16.

62. George J. Yost, *Establishing Intercompany Pricing Comparables After U.S. Steel*, 6 INT'L TAX J. 360 (1980).

because it moved the Venezuelan location advantage out of the company conducting business in Venezuela and into a tax haven subsidiary that was neither located in the country of origin or in the country where the product was shipped.

For present purposes, the critical lesson from *U.S. Steel* and its progeny is that a significant number of transfer pricing cases can be explained by the dispositive question of which party should be isolated as the "tested party" and which party should be left untested. However, few present the framing game as dramatically as in *U.S. Steel* due to the fact that residual profits in that case were allocated entirely to a tax haven subsidiary that served solely a risk taking function.[63] The risk-taker determination is, of course, a factual question upon which a taxpayer and tax authority can have dramatically different views (a factual determination challenge). The process of resolving such factual disputes is also well illustrated by *U.S. Steel*, in which the essential facts related to the taxpayer's 1957 through 1960 tax returns, and the case was ultimately resolved in 1980. Thus, any section 482-based reform that seeks to solve the HI/BEPS problem must be administrable, as outlined in tax policy objective (4).[64] These tax administration concerns with the reform proposed by this Article are explored in Part V, *infra*.

There are other cases on this subject matter reaching similar conclusions. In *Compaq Computer Corp. v. Commissioner*,[65] a U.S. computer manufacturer, Compaq U.S., formed a subsidiary in Singapore to manufacture a component, which was also purchased in substantial quantities from unrelated suppliers. The Singapore affiliate was successful in achieving worldwide material cost savings for Compaq U.S. The taxpayer designated Compaq's U.S. affiliate as the tested party and applied a one-sided transfer pricing methodology[66] to determine the profits allocable to that affiliate, whereas the Singapore affiliate was the "untested party" that kept all residual profits related to the location advantage. For the years at issue, the Singapore Economic Development Board had granted Compaq U.S.'s Singapore

63. *See* PPG Indus., Inc. v. Commissioner, 55 T.C. 928, 946 (1970) (sustaining the taxpayer's choice of tested party with the result that significant residual profits remains with the untested party); *see also* Diefenthal v. United States, 367 F. Supp. 506, 512 (E.D. La. 1973); *see also* Compaq Computer Corp. v. Commissioner, 78 T.C.M. (CCH) 20, T.C.M. (RIA) ¶ 99,220 (1999). In one case, the IRS asserted that an offshore subsidiary was a "consignment manufacturer." Seagate Tech., Inc. v. Commissioner 102 T.C. 149, 165–166 (1994). However, the Tax Court rejected such characterization because of the risks and responsibilities assumed by the subsidiary. *Id.* at 185.

64. *See* Part I, *supra*.

65. *Compaq*, 78 T.C.M. (CCH) 20, T.C.M. (RIA) ¶ 99,220.

66. The specific method was the comparable uncontrolled price method. *See* Reg. § 1.482-3(b).

affiliate a "tax holiday," so the residual profits, if allocated to the Singapore affiliate, would escape any worldwide taxation. The taxpayer claimed that the Singapore affiliate was an untested party and that the U.S. affiliate was the appropriate tested party and then sought to apply a one-sided transfer pricing methodology in order to justify the routine profit allocated to Compaq's U.S. affiliate.

The IRS argued that the Singapore affiliate should be the tested party and that its profits should only be a routine profit determined with a one-sided transfer pricing methodology.[67] The Tax Court refused to treat the Singapore affiliate as the tested party because it did not believe that the IRS presented any evidence that the Compaq U.S. affiliate was distinguishable from the comparable data set, and thus the reliability of those "comparables" was not seriously questioned.[68] Of course, this holding simply sidestepped the critical issue, because the point is that the routine functions in both Singapore and the United States could not explain the residual profits, but again the Tax Court did not address this point because the Singapore affiliate remained untested with the result that its excessive profitability did not need to be explained.

In *Diefenthal v. United States*,[69] a scrap metal dealer, Scrapco, was owned by a father and two sons, each owning a third of the total stock respectively. Scrapco had a significant number of customers in Japan, and its business required loading scrap on ocean carriers and shipping it to Japan. In order to minimize transportation costs, Scrapco entered into alleged "voyage charters" that would fix the cost of the trip, regardless of the occurrence of unforeseen delays or problems. One of the sons of the owner formed a new company, Fukaya, to conduct the shipping business with Fukaya receiving the residual profits for the geographical price difference for scrap metal sold into Japan versus its value in the U.S. marketplace. The IRS argued that the tested party should be Fukaya, not Scrapco, with the consequence that Fukaya, according to the IRS, would receive only a routine shipping profit and any excess profit attributable to the geographic differences in pricing for scrap metal belonged to Scrapco.

The court rejected the IRS's position and allowed Fukaya to be the untested party. In the course of its opinion, the court found that Scrapco had received an adequate routine profit using a one-sided transfer pricing methodology (in this case, using the comparable uncontrolled pricing method). The court also found no reason to believe that Scrapco was not comparable to the companies used in the transfer pricing study. Without

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67. The specific transactional method that the IRS believed was appropriate for testing the Singapore affiliate was the resale profits method.

68. The essence of the finding is a factual determination challenge. *See supra* note 16.

69. *Diefenthal*, 367 F. Supp. 506 (E.D. La. 1973).

evidence as to the unreliability of the comparable data set, the court accepted that Scrapco's profits should be limited solely to a routine profit comparable to the data set of companies and held that Scrapco should not share in any portion of the residual profits.[70]

Armed with these favorable decisions utilizing One-Sided Transfer Pricing Methodologies, taxpayers would understandably structure arrangements to confirm that the U.S. affiliate should be the tested party with routine profit allocable to it. For non-U.S. MNEs, the residual profits may be allocated entirely to the offshore affiliate, and the IRS would be left to discover whether any non-routine profits existed and, if so, whether the U.S. affiliate owned a non-routine intangible that contributed significantly to earning those residual profits.[71] The procedural posture of the parties presents the IRS with a difficult factual contest.

In an effort to achieve better results for the federal budget, the IRS began to formulate a variety of theories upon which to argue that the tested party and the untested party should be switched. When the IRS's argued simply that it would seek to reformulate the internal economic arrangements and risk-assignment put into place by the taxpayer, so as to place the reconstructed arrangement in a light more favorable to the government, this argument was soundly rejected.[72] Courts consistently upheld the economic and contractual relationships existing among related parties so as long as those arrangements were legitimate business transactions put into place before the risks and rewards were determined.[73] Thus, courts have rejected the idea that section 482 permitted "substance over form" arguments. On the contrary, so long as the internal MNE agreements allocated true economic risks and rewards, the IRS's authority under section 482 was solely to apply the arm's length standard to the economic fact pattern presented by the taxpayer.[74]

However, the IRS has had success where it could factually demonstrate that the "tested parties" proffered by the taxpayer were

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70. The essence of the finding is a factual determination challenge. *See supra* note 16.

71. See Part III, *infra* (discussing the *Westreco* case).

72. *See, e.g.*, Eli Lilly & Co. v. Commissioner, 84 T.C. 996, 1126–27, *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988); *see also* Charles H. Berry, *Economics and the Section 482 Regulations*, 43 TAX NOTES 741, 744 (May 8, 1989). P.L.R. 1980-40-019 (July 7, 1980) (ruling that possessions corporation to which mainland affiliate transferred intangibles found to be contract manufacturer). *See* LOWELL, BRIGER & MARTIN, U.S. INTERNATIONAL TRANSFER PRICING, *supra* note 51, at ¶¶ 3.02[1] and 9.03.

73. *See supra* notes 56–70.

74. Economic risk is considered to be substance for tax purposes. *See* LOWELL, BRIGER & MARTIN, U.S. INTERNATIONAL TRANSFER PRICING, *supra* note 51, at ¶ 3.02[1].

themselves "complex" and incapable of being benchmarked with routine external comparable companies.[75] For example, when the U.S. affiliate was the entity that engaged in manufacturing, the IRS argued that non-routine manufacturing know-how created and developed by the U.S. manufacturing affiliate entitled the U.S. affiliate to more than a routine manufacturing margin. When the posture changes such that the offshore affiliate is the manufacturer and the U.S. affiliate is the distributing entity, then the IRS sought to argue that the U.S. distributor affiliate had developed its own "marketing intangible," entitling the U.S. distributor affiliate to more than a routine distribution margin. The evolution of the concept of a "marketing intangible" is interesting and deserves further analysis. Courts have held that marketing intangibles can include customer lists, trademarks, trade names, brand names, and related customer goodwill,[76] and the IRS has asserted an even more expansive list of situations where a marketing intangible might exist in its litigating positions[77] with mixed success.[78]

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75. As noted with respect to the cases discussed *supra* and *infra*, this is ultimately a factual determination challenge. *See supra* note 16.

76. *See, e.g.*, Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930) (discussing goodwill in the nature of trademarks, trade names and trade brands); J.C. Cornillie Co. v. United States, 298 F. Supp. 887 (E.D. Mich. 1968) (discussing goodwill in the form of customer lists); F.W. Drybrough v. Commissioner, 45 T.C. 424 (1966), *aff'd*, 384 F.2d 715 (6th Cir. 1967) (discussing goodwill consisting of agency's file of uncollected claims). *See also* P.L.R. 1981-34-193 (May 29, 1981) (defining "marketing intangibles" as the right to use tradename, trademark, and related goodwill).

77. The IRS has taken an expansive view of what constitutes an intangible in several instances. *See* F.S.A. 2002-30-001 (July 26, 2002) (finding project finance developer's efforts to negotiate a comprehensive package of interdependent contracts to finance, construct, and operate a project constituted an intangible asset). *Arguably,* F.S.A. 2002-30-001 is inconsistent with the result reached in Hospital Corp. of America, Inc. v. Commissioner, where the Tax Court rejected the IRS's characterization of the negotiation of the terms of a hospital management contract as a transfer of property on the grounds that what was provided by the taxpayer did not represent a legally enforceable right and was, at best, merely a business opportunity. 81 T.C. 520 (1983), *nonacq. in part* 1987-1 C.B. 1 *See also T.A.M. 2009-07-024* (Feb. 13, 2009) (concluding that network of contracts with independent foreign agents constitutes intangible asset apart from goodwill for purposes of section 367(d)); *Merck & Co. v. United States*, 24 Cl. Ct. 73, 91-2 U.S.T.C. ¶ 50,456 (Cl. Ct. 1991) (rejecting IRS's argument that the taxpayer's strategic planning structure and system of intercompany pricing were services that required an arm's-length payment from the subsidiary to the taxpayer).

78. In *Veritas Software Corp. v. Commissioner*, the Tax Court primarily addressed a cost sharing buy-in payment and found that there was no evidence to support a finding that the transfer of access to U.S.-based research and development and marketing teams was the transfer of an intangible. 133 T.C. 297 (2009), *action*

In this posture, the path is clear for the government: if residual profits exist, then it must find some non-routine intangible in the hands of the U.S. affiliate, such as manufacturing know-how or a marketing intangible, that distinguishes the tested U.S. affiliate from the comparable data set of companies proffered by the taxpayer to support its use of a one-sided transfer pricing methodology. If the comparable data is materially and economically distinguishable, then the U.S. affiliate can be defrocked of its "tested party" status due to the fact that it owns non-routine intangibles that contribute significantly to the residual profits of the combined entity.

If such a contest is waged with a U.S. MNE, then the IRS should be able to discover the offshore profits of the untested foreign affiliate so that it can learn the amount of residual profits potentially in dispute. However, if this contest is waged with a non-U.S. MNE, the IRS would likely hear that it has no right to examine the offshore books and records of foreign affiliates until and unless the IRS is able to demonstrate that a one-sided transfer pricing methodology is not controlling and that a two-sided transfer pricing

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on decision 2010-005 (Nov. 12, 2010). As part of this discussion, the court included the following footnote 31:

> Even if such evidence existed, these items would not be taken into account in calculating the requisite buy-in payment because they do not have "substantial value independent of the services of any individual" and thus do not meet the requirements of sec. 936(h)(3)(B) or [regulation] 1.482-4(b) . . . . "Access to research and development team" and "access to marketing team" are not set forth in sec. 936(h)(3)(B) or [regulation] 1.482-4(b) . . . . Therefore, to be considered intangible property for sec. 482 purposes, each item must meet the definition of a "similar item" and have "substantial value independent of the services of any individual". Sec. 936(h)(3)(B); [regulation] 1.482-4(b) . . . . The value, if any, of access to VERITAS US' R&D and marketing teams is based primarily on the services of individuals (i.e., the work, knowledge, and skills of team members). Nevertheless, respondent in support of his contention cites Newark Morning Ledger Co. v. United States, [citations omitted]. These cases, however, do not suggest that access to an R&D or marketing team has substantial value independent of the services of an individual, do not define intangibles for sec. 482 purposes, and do not even reference sec. 482. We note that in December 2008, the Secretary promulgated temporary regulations (i.e., [regulations] 1.482-1T through 1.482-9T . . .) which reference "assembled workforce." In addition, the Administration, in 2009, proposed to change the law to include "workforce in place" in the sec. 482 definition of intangible.

methodology must be employed.[79] In either event, if the taxpayer presents a transfer pricing theory using a one-sided transfer pricing methodology, the IRS faces a difficult and contentious examination process because it must first contradict the characterization of the U.S. affiliate as the "tested party" by finding some unknown and undisclosed non-routine intangible.[80] Again, from a procedural perspective, this governmental effort occurs after the taxpayer has attempted to identify all non-routine intangibles and has transferred those identified intangibles out of the U.S. affiliate and into a foreign risk-taker affiliate well before the years in issue.

2. *Two-Sided Transfer Pricing Methodology*

In stark contrast to a One-Side Transfer Pricing Methodology, a two-sided transfer pricing methodology (comparable profit split and a residual profit split methodology in the nomenclature of the section 482 regulations) evaluates the overall income of the affiliates and determines how to allocate the combined profits between them with all parties treated as tested parties. The residual profits are divided between those affiliates that contribute to their creation in contrast to the "all or nothing" result generally available for cases decided with a one-sided transfer pricing methodology.

Furthermore, in contrast to the transfer pricing result achieved under a one-sided transfer pricing methodology, the use of a two-sided transfer pricing methodology requires that a profit allocation to a tax haven subsidiary be affirmatively explained as a precondition for any allocation. In other words, in a two-sided transfer pricing methodology paradigm, no allocation of residual profits is made unless it can be affirmatively demonstrated that the affiliate's activities made a significant contribution to the creation of the residual profits.[81] The IRS and taxpayer, a court, or competent authorities, must determine the functions that contribute significantly to the overall residual profits and then must split the residual profits based on their relative weighting of functional importance. Although these weightings may not have been clearly understood in previous years, the current reality is that advanced pricing agreement (the "APA" process) and the treaty mutual agreement (competent authority) processes have provided a defined pathway for resolving these disputes. Unfortunately, the results of such processes are not public in nature. On the other hand, there are

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79. Admittedly, the IRS could attempt to discover the information from bilateral treaty partners under exchange of information agreements with that other country, but such a process is often cumbersome and not all countries have signed such agreements.

80. A factual determination challenge. *See supra* note 16, (framing the problem of One-Sided Transfer Pricing Methodologies in terms of tax policy objective (4)).

81. Reg. § 1.482-6(b).

tabulations of public data derived from litigated cases,[82] as well as from joint venture agreements between unrelated parties, [83] which are instructive.

Stated differently, when a two-sided transfer pricing methodology is used to resolve a transfer pricing dispute, the taxpayer has the burden of showing that its allocation of residual profits follows the substantive functions that created the MNE's residual profits.[84] If the taxpayer cannot explain how a tax haven's activities functionally contributed to the creation of residual profits, it would receive a zero allocation. Nothing is left unexplained in a profit-split approach that employs a two-sided transfer pricing methodology because the contributions of the various affiliates must be demonstrated as a condition precedent for an allocation of income. As the income allocation tracks the functions that create the income in a two-sided transfer pricing methodology, an allocation of homeless income that is divorced from those substantive functions is unachievable.

The IRS's first significant success in getting a court to utilize a two-sided transfer pricing methodology was the landmark case of *Eli Lilly & Co. v. Commissioner*.[85] Eli Lilly & Co. (Lilly) is a large producer of pharmaceuticals. In *Eli Lilly*, a compound was discovered in 1951 (propoxyphene and propoxyphene hydrochloride) for which Lilly received a patent in 1955 and the FDA approved the compound for the market. Several related products were marketed that used the compound as their principal active ingredient. A closely related compound (propoxyphene napsylate) was subsequently developed, for which a patent was issued in 1962, and FDA approval was obtained in 1971. Products based on this patent were then marketed. Although Lilly's Puerto Rican affiliate owned the patents, the issue remained as to the profit split between a patent owner and the U.S. affiliate that developed the market for the patented drug. The Tax Court clarified the distinction between manufacturing intangibles (owned by an offshore manufacturing affiliate) from marketing intangibles (owned and developed by the U.S. affiliate).

The Tax Court found that the marketing intangibles owned by the U.S. affiliate included the trademarks for certain pharmaceutical compounds as well as the Lilly name and goodwill of the company. In describing the marketing intangible owned by the U.S. affiliate, the Tax Court said that the U.S. affiliate enjoyed a favorable reputation in the U.S. marketplace and had developed a marketing organization that was highly skilled. The Tax Court found that the U.S. affiliate's marketing intangible had significant value apart from the patents owned by the offshore manufacturing subsidiary. The

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82. *See infra* note 97.

83. *See infra* note 100.

84. Reg. § 1.482-6(b)(2).

85. Eli Lilly & Co. v. Commissioner, 84 T.C. 996 (1985), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988).

Tax Court stated that the U.S. affiliate owned these valuable marketing intangibles because the U.S. affiliate developed this market recognition, trade name, and customer goodwill entirely from its own funds without reimbursement by the offshore Puerto Rican affiliate.[86] Concluding that both the manufacturing intangible and the marketing intangible contributed significantly to the residual profits of the MNE, the Tax Court did not believe that a one-sided transfer pricing methodology was appropriate as the record did not contain any transactions comparable to either affiliate on a stand-alone basis.

Accordingly, the Tax Court turned to a two-sided transfer pricing methodology. In this process, each identified function was provided a profit allocation. However, with respect to the residual profits remaining after the allocation of the routine profits, the court concluded that the U.S. distributor affiliate should receive 45 percent of the residual profit for its marketing intangibles and the Puerto Rican affiliate should receive 55 percent as the owner of the manufacturing know-how and product patent based on the Tax Court's assessment of the relative contribution of each of the affiliates' functions to the generation of the residual profits.[87]

G.D. Searle & Co. v. Commissioner[88] is largely consistent and supported the holding in *Eli Lily*. The Tax Court again found that there was "little hard evidence" before it and that the comparables in the record were unreliable.[89] The Tax Court observed that the intangibles transferred to offshore affiliate SCO "were of little value to SCO without the marketing and administrative services provided by the U.S. affiliate (Searle), because SCO was unable to provide such services for itself."[90] Additionally, Searle continued to own the new drug applications (NDAs) issued by the Food and Drug Administration with respect to the products manufactured by SCO, meaning that without Searle's services, SCO could not have sold its products.[91] The NDAs owned by Searle "were also extremely valuable assets, without which the . . . intangibles [transferred to SCO] were of diminished value."[92] The Tax Court found that there was no adequate

86. *See also* G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987) (holding that the transferred manufacturing intangibles had "little value" to SCO apart from the intangibles associated with the "marketing and administrative services" provided by Searle and engaging in an effort to bifurcate the combined company goodwill between the manufacturing intangible owned by the manufacturing subsidiary and the marketing intangible owned by the distributor subsidiary). *Id.* at 375.

87. *Eli Lilly*, 84 T.C. at 1130–67.

88. *Searle*, 88 T.C. at 252.

89. *Id.* at 373.

90. *Id.* at 375.

91. *Id.*

92. *Id.*.

evidence before it to determine how to allocate the residual profits when both the U.S. affiliate and the offshore affiliate owned significant non-routine intangibles, and therefore the Tax Court used its best judgment and determined that an allocation of profits to the U.S. affiliate equal to 25 percent of SCO's total net sales in 1974 and 1975 was appropriate in order to clearly reflect the U.S. affiliate's income.[93] The net result of the allocation was that about 54 percent of the combined net profit of SCO and Searle from the products produced by SCO was attributed to Searle, the owner of the marketing intangible, and 46 percent was allocated to SCO, the offshore manufacturer which owned the patent for the product. While the Tax Court did not articulate its conclusion as a profit split, this was the effect of its determination.

In *Bausch & Lomb v. Commissioner*,[94] a foreign manufacturing affiliate licensed valuable intellectual property from its U.S. parent, the patent owner, and the issue involved how to determine the appropriate transfer pricing result between these affiliates. After allocating a profit among the affiliates for various other routine functions, the Tax Court found that no unrelated party comparables existed for the intangible property and stated that it must construct its own arm's length royalty to allocate the residual profits from the patented product between the patent owner and the licensee of the patent.[95] The Tax Court then used its best judgment to find that the arm's length royalty should be 20 percent, which would allow B&L Ireland, the licensee, to share in about 50 percent of the residual profits derived from the licensed technology and earn a 27 percent return on its investment over the course of the project.[96]

The cases discussed in this Article are representative of the larger picture. A broader cataloguing of all resolved transfer pricing disputes using a two-sided transfer pricing methodology demonstrates that on an aggregate basis (after eliminating a single case that is so large so as to adversely influence the overall results) courts have allocated residual profits on about a 50:50 basis between the U.S. affiliate and the foreign affiliate where both affiliates possess material, non-routine intangibles that contribute significantly to the creation of residual profits.[97]

Such results are consistent with the historical evolution of transfer pricing concepts. As noted above, the current principles evolved in the period immediately after World War I. The initial tax treaty and transfer pricing

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93. *Id.* at 376.

94. Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991).

95. *Id.* at 600.

96. *Id.* at 611.

97. *See* LOWELL, BRIGER & MARTIN, U.S. INTERNATIONAL TRANSFER PRICING, *supra* note 51, at Appendix ¶ B.02[2] (noting that actual result on a profit split basis is about 48 percent for the government and 52 percent for the taxpayer).

paradigm was developed by the International Chamber of Commerce (ICC), and it employed a methodology that would have allowed countries to bilaterally agree on a functional analysis concerning how to split profits between the two countries. In the absence of an agreement, there would have been a default 50:50 profit-split (a two-sided transfer pricing methodology).[98] With the benefit of the subsequent U.S. litigation record noted previously in this Article, the 50:50 default split was prescient. Of course, the ICC's tentative working draft was rejected by the League of Nations, the forbearer of the current OECD/UN treaties.[99]

Similar results can be found in other sources. Public databases often contain joint venture agreements between unrelated parties, which ultimately utilize profit split mechanisms in allocating the combined income from the joint activity.[100] Furthermore, experience in Mutual Agreement (competent authority) resolutions reflects a similar process. In such proceedings, there are necessarily two taxing authorities evaluating the transfer pricing issues on the table for resolution. In the experience of the Authors in resolving major bilateral cases, it is virtually inevitable that resolution will ultimately be based upon evaluation of Two-Sided Transfer Pricing Methodologies, either directly or indirectly. Where a MNE declines to provide such data, the case will often stall or fail in resolution. Furthermore, a long delay in

98. *See infra* note 127. The original proposal by the International Chamber of Commerce, and its historical significance along with its rejection in favor of the current paradigm that creates homeless income is addressed elsewhere. *See* Bret Wells & Cym Lowell, *Income Tax Treaty Policy in the 21st Century: Residence vs. Source*, 5 COLUM. TAX J. 1 (2013) [hereinafter Wells & Lowell, *Treaty Policy in the 21st Century*].

99. There also were treaty arrangements negotiated in Eastern Europe later in the 1920s that utilized similar profit split methodology. *See* Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 549–61.

100. Actual agreements must be included in submissions to the Securities and Exchange Commission where the agreement is material to the U.S. registrant's business. Such agreements can be quite useful as comparable for profit split analysis, including resolution of bilateral APA or Competent Authority matters. *See, e.g.*, Joint Venture Agreement Between Warner-Lambert Company and Wellcome P.L.C., Warner Lambert Form 10-K (Mar. 23, 1994) (addressing essentially agreement between unrelated parties for the non-U.S. party to manufacture products for which it owned the intangibles and the U.S. party to distribute the products, with a profit split of 75 percent for the U.S. distributor and 25 percent for the non-U.S. manufacturer); Global Principles Agreement between Warner Lambert Company and Glaxo Holdings P.L.C., Warner Lambert Co. Form 10-K (Mar. 23, 1994) (including a similar structure as Wellcome with a profit split of 50:50). Like other comparable searches, such data can be developed for industries and functional activities in question, then formatted for use in two-sided transfer pricing methodology analysis.

resolution often results from a failure to provide effectively combined income data.

This background of Two-Sided Transfer Pricing Methodologies is instructive with respect to the search for a solution to the HI/BEPS problem. In the context of the litigated cases noted above, joint venture arrangements, or non-public competent authority APA resolutions where Two-Sided Transfer Pricing Methodologies are utilized, there is no homeless income or base erosion. The reasoning behind such a result is that the full range of combined income relating to the parties and economic functions is on the table and the combined profits get allocated in accordance with those substantive functions. There is no residual profit that is not taken into account.[101]

3. Cost Sharing Regulations: In the Middle

a. Background

The ability to assign residual profits to a risk taker and away from the affiliate whose functions create that value is a theme that has been clearly played out through the use of One-Sided Transfer Pricing Methodologies. However, it is also a theme that has been repeated to similar effect through the use of cost sharing arrangements (CSAs) entered into among MNE affiliates. Essentially, CSAs compliant with the section 482 transfer pricing regulations allow two or more controlled parties to share the costs and risks of a research and development project for an agreed upon scope in exchange for a specified interest in the results of the project. As the participants jointly own the developed technology, there is typically no royalty obligation with respect to the use of the technology by any participant. Consideration for use of intangibles developed in a CSA is paid in advance during the course of development as opposed to after the development (typically as royalties) where the intangibles are developed by another person. In effect, a CSA involves multiple developers.

The IRS has struggled with the cost sharing regulations from a U.S. tax base defense standpoint since the mid-1960s.[102] In the pre-1986 cases,

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101. In this regard, significant economic work has been undertaken to demonstrate that the use of profit-split methodologies are the least distortive means of allocating profits and the least susceptible to taxpayer planning efforts. *See* Rosanne Altshuler & Harry Grubert, *Formulary Apportionment: Is It Better than the Current System and Are There Better Alternatives?*, 63 NAT'L TAX J. 1145, 1166–67 (2010).

102. Administrative guidance was initially provided in the 1966 proposed regulations. Prop. Reg. § 1.482-2(d)(4)(i), 31 Fed. Reg. 10,394, 10,398 (1966). When the section 482 regulations were finalized in 1968, the provisions applicable to

courts typically sided with taxpayers.[103] While the Tax Reform Act of 1986 Act did not specifically address CSAs, the legislative history indicates that the commensurate-with-income provisions of sections 367(d) and 482 were not intended to prevent appropriate use of such arrangements.[104] The regulatory experience of the succeeding decades has been that the cost sharing regulations have become more and more complicated.[105]

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cost sharing were considerably reduced and simplified, with the content compressed from several pages to only one paragraph. T.D. 6952, 1968-1 C.B. 218.

103. The first significant cost-sharing case was *Seagate Technology, Inc. v. Commissioner*, 102 T.C. 149 (1994), *acq.* 1995-2 C.B. 1. A U.S. MNE, "S," established a Singapore subsidiary (SSing) to manufacture disk drives. The IRS asserted that the cost share of SSing should be increased to reflect relative production. The evidence indicated that by 1987 the preponderance of manufacturing in SSing suggested that a sharing ratio of 75 percent and 25 percent as between SSing and S was reasonable. Experts testifying for the IRS stated that shares should be based on the relative production of disks, which over the three years in question would have resulted in an 84 percent and 16 percent split. The court found that the record did not contain any uncontrolled cost-sharing arrangements that could be consulted for guidance and used its "best judgment" to conclude that 75 percent of the costs should be allocated to SSing and 25 percent to S. *See also* Altama Delta Corp. v. Commissioner, 104 T.C. 424, 463–72 (1995) (applying the cost-sharing method in the context of the possession corporation cost-sharing provisions); Ciba-Geigy Corp. v. Commissioner 85 T.C. 172, 222 (1985) (rejecting IRS's position that a generalized facts and circumstances approach should be applied to an arrangement similar to a CSA in favor of the provisions of the intangibles section 482 regulations).

104. Specifically, the legislative history to the Tax Reform Act of 1986 [hereinafter 1986 Act] indicated that Congress did not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent that the income allocated among the parties reasonably reflects the actual economic activity undertaken by each. Pub. L. No. 99-514, 100 Stat. 2085 (1986). *See* STAFF OF THE JOINT COMMITTEE. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1017 (1987), http://www.jct.gov/jcs-10-87.pdf. In order for cost-sharing arrangements to produce results consistent with the commensurate-with-income provisions of the 1986 Act, it was envisioned that cost allocations should generally be proportionate to profits determined before deduction for research and development costs. In addition, to the extent that one party actually contributes funds at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be expected that an appropriate return would be provided to such party to reflect the time value of this investment.

105. *See* Notice 88-123, 1988-2 C.B. 458 [hereinafter 1988 White Paper]. The 1988 White Paper provided a detailed analysis of how those provisions of the 1986 Act should be applied to CSAs. The 1988 White Paper seemed generally to take a rather restrictive approach. 1988 White Paper. *Id.* at 495. The stringent requirements of the 1988 White Paper were roundly criticized by commentators, and

For the purposes of this Article, the fundamental principle behind the existing and previous cost sharing regulations is that they explicitly sanction results that are unlikely to be consistent with those allowed under a two-sided transfer pricing methodology. The fundamental discrepancy is that the cost sharing regulations look to allocate residual profits based on anticipated future benefits,[106] whereas a two-sided transfer pricing methodology seeks to allocate residual profits based on the relative functional contribution towards the creation of the non-routine intangible generating those residual profits.[107]

Where a CSA is put into place among parties that both contribute non-routine intangibles and where their cost shares (i.e., their expected future benefits) are equivalent to their relative contribution of the non-routine functions creating the developed intangible, then those achieved under the cost sharing regulations should mirror the results provided by a two-sided transfer pricing methodology conducted under the rubric of Regulation section 1.482-6. Thus, in such a fact pattern, the CSA formalizes an arrangement that harmonizes with the results achieved under the profit-split approaches, thus representing an "appropriate method of allocating income" in the spirit of the legislative history to the 1986 Act.

On the other hand, when a CSA allows an MNE to choose a risk taker affiliate to fund the intangible development for an amount in excess of its functional contribution towards the creation of that developed intangible, then the cost sharing regulations allow the residual profits to be stripped away from the functions that created those residual profits and given to the offshore "risk-taker."[108] This result is similar to the one afforded under the application of a one-sided transfer pricing methodology. Similar to placing principal reliance on One-Sided Transfer Pricing Methodologies, such

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a more lenient set of provisions was proposed in 1992. Prop. Reg. § 1.482-2(g)(1)(i), 57 Fed. Reg. 3571, 3575 (1992). The IRS issued final cost-sharing regulations on December 20, 1995. T.D. 8632, 60 Fed. Reg. 65553, 1996-1 C.B. 85 (1995). The final regulations largely followed the 1992 proposed regulations, but made several important alterations. *Id*. The IRS issued proposed regulations restating the CSA regulations in August 2005. *See* 70 Fed. Reg. 51116 (2005). On December 31, 2008, final and temporary regulations were issued. T.D. 9441, 74 Fed. Reg. 340, 2009-7 I.R.B. 460 (2009). These regulations had been proposed in 2005 to replace the 1995 regulations. The 1995 regulations were controversial, reflecting the conflicting interests of MNEs and the public fisc with respect to the cross-border use or transfer of intangible property. In 2011, final, temporary, and proposed regulations were released. T.D. 9569, 76 Fed. Reg. 80,249 (Dec. 23, 2011), finalizing the 2009 version with relatively modest substantive change.

106. *See* Reg. § 1.482-7(a)(1).

107. *Compare* Reg. § 1482-6(a), *with* Reg. § 1.482-7(b)(1)(i), *and* (e)(1).

108. *See* Reg. § 1.482-7(a)(1), (b)(1)(i), and (e)(1).

utilization may yield results that vary significantly from those achieved under Two-Sided Transfer Pricing Methodologies.[109]

From the standpoint of devising a section 482 solution to the HI/BEPS problem, Regulations section 1.482-7 should be amended to say that all allocations of residual profits via a CSA (whether a pre-existing CSA or a new CSA) will be respected in future years only to the extent that the CSA allocates residual profits in the same manner as would occur under a straightforward application of a two-sided transfer pricing methodology set forth in Regulations section 1.482-6.

Section 367(d) provides the IRS with authority to require all transfer pricing arrangements, including CSAs, to comply with the commensurate income requirements regardless of which entity owns the intangible, and the IRS should say that a CSA's assignment of residual profits to a risk-taker satisfies the commensurate-with-income requirements only if the results are in accord with the results achieved with a two-sided transfer pricing methodology. The IRS is on record as having asserted authority under section 367(d) to require pre-existing CSAs to comply with the commensurate-with-income standard, and it should now follow-through on that authority.[110] Instead of exercising that authority to harmonize the

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109. The problem of how to source intangible income has been explored by others without academic agreement. *See* Graetz & Doud, *Technological Innovation, supra* note 4 (discussing and cataloging several possible policy options); Ilan Benshalom, *Sourcing The "Unsourceable:" The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631 (2007) (proposing that manufacturing intangibles be sourced according to where their value was created whereas marketing intangibles should be sourced to where they were created based on sales); Lawrence Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 235 (1981) (discussing sourcing intangible income to the place where the intangible value is sold or where manufactured); Erin L. Guruli, *International Taxation: Application of Source Rules to Income From Intangible Property*," 5 HOUS. BUS. & TAX L.J. 204 (2005) (sourcing intangible income to where intangible value is sold); David G. Noren, *The U.S. National Interest in International Tax Policy*, 54 TAX L. REV. 337 (2001) (sourcing intangible income to where sale is made). The OECD released a draft proposing that intangibles should be sourced to the functions that created them. *See* OECD, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 2012 TAX NOTES TODAY 110-37 (June 6–Sept. 14, 2012). The view taken by the OECD is if the HI/BEPS problem is to be solved, residual profits must be sourced to the functions that contributed to their creation, not based on the entity that will benefit from them.

110. *See* 1988 White Paper, *supra* note 105, at Chapter 13(J). The White Paper states as follows:

> It is unlikely that there will be preexisting cost sharing agreements that will meet all of the standards described above.

residual profit allocations afforded under the cost sharing regulations to the residual profit allocations afforded under Regulations section 1.482-6, the IRS has instead limited its policing of CSAs to contesting (i) the buy-in payment amount for pre-existing intangibles[111] and (ii) whether the MNE had included all of the intangible development costs as part of the cost shares.[112] But in each of these factual settings, the IRS has faced a significant factual determination challenge. Furthermore, the existing cost sharing regulations grandfathered even more lenient CSAs entered before the issuance of the

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> If such agreements are not recognized, the Service and taxpayers will encounter significant problems in determining ownership of preexisting intangibles and the treatment of the payments that have been made pursuant to the preexisting agreements. Some type of grandfather treatment would therefore appear to be appropriate. One possibility would be to permit any cost sharing agreement that conforms to the requirements of the existing regulations, and that has been in existence for more than 5 years prior to 1987, to be recognized fully if conformed within a certain period after the promulgation of the new rules with respect to matters other than the buy-ins that occurred prior to June 6, 1984 (the effective date of section 367(d)). If the cost sharing agreement has been in effect for less than 5 years and the agreement does not conform substantially to the new rules, then the old agreement would not be recognized. If a new agreement that conforms to the new rules is adopted, then all payments pursuant to the old agreement would be taken into account as an adjustment to any required buy-in payments relating to the new agreement.

Consistent with the above methodology, the IRS could require that all CSAs conform their tax results to those resulting from Two-Sided Transfer Pricing Methodologies of Regulations section 1.482-6 regardless of which affiliate is the tax owner of the nonroutine intangible if the ownership was acquired by a CSA entered into after the effective date of section 367(d). This regulatory requirement would ensure that the affiliate that created the nonroutine intangible was in fact allocated the residual profits commensurate with that residual income under the principles of section 367(d). The IRS could provide a short transition rule (two years or less) for having taxpayers subject their existing CSAs to a Two-Sided Transfer Pricing Methodology as a confirming check to the results achieved under Regulation §1.482-7.

111. *See* Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009) (where the IRS unsuccessfully argued that the buy-in payment should have been 1000% higher than the one utilized by the taxpayer, and the Tax Court sustained the taxpayer's valuation of the buy-in payment); A.O.D., 2010-49 I.R.B. 803 (Dec. 6, 2010), http://www.irs.gov/pub/irs-aod/aod201005.pdf.

112. *See* Xilinx, Inc. v. Commissioner, 567 F.3d 482 (9th Cir. 2009) (rejecting IRS position that stock option costs should be included in the cost to be shared among the parties).

current regulations.[113] Thus, existing Regulations section 1.482-7 provides significant opportunities for an MNE to utilize a CSA to assign a foreign risk-taker affiliate the right to residual profits for intangible property created by other affiliates without the need to provide any further significant contribution towards their creation other than internal funding. The building blocks for the HI/BEPS problem are immediately apparent, and the disparity in transfer pricing results compared to that afforded under Regulations section 1.482-6 could not be starker.

b. Pertinence to the HI/BEPS Problem

In our view, if policy-makers are serious about stopping the existence of a base eroding risk-taker model, then a CSA between related parties should not be allowed to allocate residual profits to a risk-taker in excess of the risk-taker's functional contribution towards the creation of the intangible that generates those residual profits. The risk-taker function standing alone is typically a routine function within an MNE group and does not contribute significantly to the creation of nonroutine intangibles. Nonetheless, regulations section 1.482-7 treats funding as if it were the sole function that mattered. Funding is often purely an internal treasury management question. The cost sharing regulations allow parties to divvy residual profits based on cost sharing percentages,[114] and these funding percentages are not necessarily based on relative contribution towards the creation of the non-routine intangible but instead on the reasonably anticipated benefits derived from the created intangible.[115]

The better answer is to provide the risk-taker affiliate with a routine return for its risk capital funding function[116] and then split the residual profits based on the relative functional contribution of the affiliates towards the creation of the developed intangible. This approach allocates the residual profits to the entity in proportion to the relative contribution that its functions bear to the creation of those residual profits. If the residual profits are

113. *See* Reg. §1.482-7(m)(1).

114. Reg. § 1.482-7(a)(1), -7(b)(1)(i).

115. *See* Reg. § 1.482-7(e)(1).

116. *See* Bausch & Lomb v. Commissioner, 92 T.C. 525, 611. In fact, in this case, the party funding the research was entitled to receive a 27-percent return on its funding investment and then residual profits were split based on the relative contribution of the functions. The Tax Court stated as follows as to the return that the risk-taker should take: "[w]e can assume that the 12-percent rate used to discount future cash-flows in the SEA projections constituted petitioner's estimate of the acceptable rate of return on a relatively riskless venture. The additional 15 percentage points earned by the investor can thus be viewed as compensation for assuming the risks involved in the venture." *Id.* This aspect of the Tax Court's holding in *Bausch & Lomb* could be adopted in regulations.

generated by both manufacturing intangibles and marketing intangibles that were created by different entities, then a profit-split should be done between these two intangibles based upon their relative contributions.

In the legislative hearings relating to the HI/BEPS problem, CSAs have played a prominent role.[117] If public statements are to be believed, in the case of Apple, Inc.,[118] its tax haven affiliate funded $5 billion of its research and development expenditures and in return was allocated $79 billion of income or $74 billion in residual profits (net of the research expenditures).[119] In our proposal, Apple's tax haven subsidiary would not be entitled to share in the residual profits unless it met the functional standard. As a general rule, a risk-taker is not a "function" that creates residual profits.[120] Instead, in our proposal, the residual profits would be allocated to the affiliate whose functions contributed to the creation of the valuable intangible. If all functions that contributed to the creation of the developed intangible were located in the United States, then all of Apple's residual profits should be allocated to the United States. If, however, a significant nonroutine European marketing intangible existed in the Apple fact pattern and that European marketing intangible contributed towards the generation of the combined residual profits, then the residual profits should be split based on the relative contribution of the offshore marketing intangible's contribution versus the contribution of the other intangibles that contributed to Apple's combined residual profits. But, in any case, the residual profits would only be allocated to those entities whose activities contributed to the development of the intangible that generated the residual profits. Thus, under a two-sided transfer pricing methodology, residual profits would not be

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117. *See Offshore Profit Shifting Hearing (Apple, Inc.)*, *supra* note 21; *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*, *supra* note 21, Staff Memorandum to the Members of the Senate Permanent Subcommittee on Investigations (May 21, 2013).

118. The authors have no personal knowledge of the Apple tax situation, and as a general rule would not comment on a particular taxpayer situation in our writings outside the context of decided cases. However, Apple has explicitly invited the public to consider its tax structure as part of the ongoing comprehensive tax reform debate. See *Offshore Profit Shifting Hearing (Apple, Inc.)*, *supra* note 21, (statement of Tim Cook, Chief Executive Office of Apple, Inc.). Mr. Cook stated that Apple welcomes an objective evaluation of the U.S. corporate tax system, that Apple provided its information as a means to provide information "critical to any objective evaluation of its tax practices," and that Apple supports comprehensive U.S. corporate tax reform "even though it would result in Apple paying more U.S. corporate tax." *Id.* Thus, we comment on the publicly-disclosed facts for the purpose of answering the question of whether Section 482 can be reformed to prevent inappropriate shifting of profits to tax havens via CSAs.

119. See *Offshore Profit Shifting Hearing (Apple, Inc.)*, *supra* note 21, at 4, n.6 (Statement of Richard Harvey, Jr., Villanova University School of Law).

120. *See supra* note 116.

shared with the Apple Irish risk-taker affiliate absent a substantive functional contribution (which was not readily apparent from the publicly-disclosed documents).[121] Instead, that Irish risk-taker affiliate would be provided a routine profit for its routine risk capital function.

c. *Similar Attention for Inbound Matters*

Similar CSA base erosion techniques can be achieved by non-U.S. MNEs doing business in the United States through affiliates. Thus, it is important to ensure that targeted reforms apply equally to non-U.S. MNEs and U.S. MNEs alike. In this analysis, Nestle (a non-U.S. MNE) provides the same fundamental HI/BEPS problem as the Apple fact pattern, and thus it represents an appropriate non-U.S. MNE to consider from a reform perspective.[122]

In *Westreco, Inc. v. Commissioner*,[123] Nestle's U.S. affiliate (Westreco) conducted U.S.-based research that created highly valuable non-routine intangibles. The U.S. affiliate was allocated a routine service profit for its research activities since it was designated as a "contract researcher" for Nestle's offshore risk-taker affiliate. The offshore Nestle "risk-taker" affiliate then turned around and charged Nestle's U.S. manufacturing and distribution affiliates for their use of the U.S.-developed nonroutine intangibles. The result of this "round-trip" tax planning was that the Swiss risk-taker affiliate kept all of the residual profits even though the intangible was created in the United States by a U.S. affiliate, was used in manufacturing activities in the United States by another U.S. affiliate, and the products produced from the intangible were distributed in the United States by a U.S. affiliate. Since all of the functions that could have contributed to the creation of the residual profits (whether research activities, manufacturing activities, or marketing activities) were conducted by U.S. affiliates within the United States, the IRS attempted to argue that the U.S. affiliates of Nestle were entitled to the U.S. origin residual profits arising from the creation and exploitation of this intangible and that the offshore Swiss risk-taker affiliate should not be entitled to these U.S. origin residual profits. But, the Tax Court disagreed, finding that the U.S. affiliates were appropriately treated as "tested parties" and that the routine service profit left to Westreco (the research affiliate) was within the range of comparable

121. *See Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*, *supra* note 21, Staff Memorandum to the Members of the Senate Permanent Subcommittee on Investigations (May 21, 2013).

122. As will be further explored in Section IV.C., *infra*, residency-based reforms that attack the HI/BEPS problem fail on this account as they are directed only at U.S. MNEs and fail to address non-U.S. MNEs.

123. Westreco, Inc. v. Commissioner, T.C.M. 1992-561, 64 T.C.M. (CCH) 849 (1992).

companies. The Tax Court allowed the offshore Swiss affiliate to remain an untested risk-taker affiliate and did not address the reason that it was entitled to retain residual profits from activities that arose solely within the United States.

Nestle in this case, like Apple in the hearings, has introduced its CSA tax planning into the tax reform debate, presumably to aid in the current discussion of how tax reform should be formulated. In testimony before Congress where it urged Congress to reform the United States tax system, Nestle stated as follows:

> Nestle is a very large company, obviously. We are big boys, we can handle ourselves with the regulations and the IRS. . . . I know in the transfer pricing area, for example, we have been to court now three times on our royalties [charged to U.S. manufacturing affiliates]. Our business model is, like many U.S.-headquartered companies, to maintain our intellectual property in our home country Switzerland. It is less expensive to do, because of the synergistic nature of it. So trademarks, R&D, et cetera, and we charge out globally for it, in the form of royalties for both trademarks and R&D, *although we conduct a lot of R&D [in the United States].*
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> So dealing with the IRS on these issues, we have had battles with them, we have gone to court three times, went to trial once, summary judgment once, and then a settlement once. [At] [sic] trial, summary judgment we won 100 percent, settlement we won well over 90 percent.[124]

The Nestle planning is interesting. Nestle admitted that the United States research function creates the intangible and yet the offshore risker-taker affiliate receives the tax ownership of the resulting nonroutine intangible and then is able to charge the U.S. manufacturer/distributor affiliates a royalty to strip out the residual profits derived from activities that exploit this intangible in the U.S. marketplace. Thus, Nestle's "round-trip planning" allows the residual profits from U.S. functions, all of which appear to be conducted from within the United States by U.S. affiliates, to be stripped away from those U.S. affiliates even though the functions performed by those U.S. affiliates created the residual profits. In the end, U.S. origin

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124. *See Tax Reform and Foreign Investment in the United States: Hearing before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means*, 112 Cong. at 45 (2011) (testimony of Alexander Spitzer, Senior Vice President-Taxes, Nestle Holdings, Inc.) (emphasis added).

profits are entirely allocated to the offshore Swiss risk-taker affiliate that funded the creation of the intangible but appears to have provided no further meaningful activity towards its creation other than funding.

In our view, the residual profits arising from the Nestle fact pattern should be subjected to a two-sided transfer pricing methodology. The Swiss affiliate would be entitled to only a routine profit for providing risk capital. The residual profits derived from the created intangible would be shared by the U.S. affiliates based on their relative contribution towards the creation of the intangible that generated those residual profits as prescribed by Regulations section 1.482-6, and neither a one-sided transfer pricing methodology nor a CSA should be able to change that allocation.

Conceptually, the outbound Apple illustration is similar to the inbound Nestle/Westreco illustration, so any reform proposal should deal equally with both the Apple and Nestle/Westreco fact patterns without scapegoating either type of MNE. MNEs are simply using the rules and formulation of section 482 that has been promulgated, but it is helpful to understand their planning to properly focus where reform should be targeted.

Thus, the Apple/Nestle fact patterns bring into focus the fundamental failure within section 482, and that failure lies at the feet of One-Sided Transfer Pricing Methodologies and CSAs that allow residual profits to be allocated to an affiliate other than in accordance with that affiliate's functional contribution towards the creation of those residual profits. Under either a one-sided transfer pricing methodology or a CSA, the result is the same: residual profits are shifted under current law to an offshore risk-taker affiliate without explanation and without relationship to the contribution of their substantive functional activities. Reforms that leave this basic section 482 mistake in place (such as Subpart F reforms) only deal with U.S. MNE profit-shifting in an ad hoc way and entirely fail to address other forms of profit-shifting. A more comprehensive and thoughtful reform is called for to formulate a solution to the HI/BEPS problem.

4. *Principles For Reform of Section 482*

The above analysis can be synthesized as follows:

a. Utilization of One-Sided Transfer Pricing Methodologies and CSAs can create an "all or nothing" result for MNEs that possess residual profits and thus provide a significant planning opportunity to locate residual profits in a tax haven jurisdiction as long as the MNE can sustain its argument that the tax haven subsidiary is an untested party. One-Sided Transfer Pricing Methodologies reach this result by simply assuming away the need to explain the reason for allocating residual profits to the untested party by making the simplifying assumption that it is entitled to what remains after the one-sided allocation. CSAs reach this result by

allocating residual profits based on expected future benefits and not on the relative contribution towards the creation of that residual value. In either scenario, One-Sided Transfer Pricing Methodologies and CSAs allow residual profits to be allocated in a manner other than towards the functions that created those residual profits.

b. Two-Sided Transfer Pricing Methodologies require that all non-routine intangibles must be identified and require all residual profits to be allocated based on the relative substantive functional contribution of each affiliate towards the creation of those profits. Residual profits are allocated to an affiliate only if it is affirmatively shown that it possesses a nonroutine intangible that contributes significantly to the creation of those residual profits. When such a showing is made, then an allocation of residual profits is made commensurate to that affiliate's functional contribution towards the creation of the intangible that generated those residual profits, but only to that extent.

c. Conflict between the "all or nothing" result generally reached with the One-Sided Transfer Pricing Methodologies versus the profit-split approach utilized with a two-sided transfer pricing methodology can create a significant level of disagreement.[125] Furthermore, non-U.S. MNEs may desire to use hide-the-ball audit strategies with respect to the profitability of their non-U.S. affiliates since any indication that residual profits exist in the combined income of the MNE would cause the IRS to further explore whether the U.S. affiliate possesses any significant non-routine intangible that could be said to have significantly contributed to the existence of those residual profits. All of these elements contribute to the challenging fact-finding exercise that exists in the current transfer pricing paradigm. The principles provide a pathway to reforming section 482, as will be discussed in Part V. Before addressing such reform, however, it is important to understand why these defects have remained unaddressed for so long.

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125. Arguably the highest profile contest involving the issue of whether to use a one-sided or two-sided transfer pricing methodology was *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, T.C. Docket Nos. 5750-04 and 6959-05 (settled 2006), where the IRS assessed a $4.6 billion tax deficiency against the U.S. distribution subsidiary of a U.K. based pharmaceutical manufacturer based on the purported value of marketing intangibles developed and used by the U.S. subsidiary. The case was ultimately settled prior to trial. *See* IR-News Rel. 2006-142, 2006 U.S. Tax Rep. (RIA) ¶ 86,437.

C. *Model Treaty (Residence Country Receives the Residual Profits)*

The United States has fulminated about the HI/BEPS problem since the beginning of the global tax debate following World War I.[126] A logical question at this point is why the HI/BEPS problem has not been solved if it is in fact solvable in the section 482 context. We believe, based on the historical record, that the HI/BEPS problem has not been solved because the existing model treaties and the application of the arm's length standard using One-Sided Transfer Pricing Methodologies were purposefully developed to facilitate the purposeful over-allocation of residual income to residence countries when these models were formulated in the 1920s by the League of Nations, and the United States has dutifully signed on to that paradigm.

Current literature tends to accept the existing treaty and transfer pricing rules as a historical effort to prevent international double taxation. But, with that said, what needs greater focus at this time is that an important second goal of those formative efforts was to ensure that residual profits would be base-eroded out of source countries in favor of residence countries.[127] The victors of World War I were the capital exporting nations of the world. Those countries desired to ensure that the source countries (former colonies) would only be allocated routine profits and the remainder of profits (the coveted residual profits) would be allocated to the developed nations of the world where the capital and know-how were presumed to reside.[128]

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126. The historical record is extremely useful and illuminating to this discussion and has been exhaustively discussed by the authors elsewhere. *See* Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22 at 577–99; *see also* U.S. GENERAL ACCOUNTING OFFICE, INTERNATIONAL TAXATION: UPDATED INFORMATION ON TRANSFER PRICING, 2–8 (1993) (statement of Natwar M. Gandhi, Tax Policy and Administration Issues), http://gao.justia.com/department-of-the-treasury/1993/3/international-taxation-t-ggd-93-16/T-GGD-93-16-full-report.pdf.

127. The historical development of the model treaty and the existing transfer pricing paradigm that created the homeless income problem is beyond the scope of this article, but it is exhaustively dealt with by the authors in an earlier work that grapples with the historical development of the existing flawed paradigm. See Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 545–98.

128. *League of Nations Report on Double Taxation*, League of Nations Doc. E.F.S.73.F.19, 48, 51 (1923) (reporting findings of Professors Bruins, Einaudi, Seligman and Sir Josiah Stamp to Financial Committee of the League of Nations). Professor Seligman later explained that the objective in the 1923 Economic Expert Report was to assign "all intangible wealth, except wealth arising from mortgages on real property, either predominately or wholly to [the country of residence and away from the source country.]" *See* EDWIN R.A. SELIGMAN, DOUBLE TAXATION AND INTERNATIONAL FISCAL COOPERATION, 127 (1928). This preference for primacy of residency taxation over source taxation was followed through in subsequent work by the League of Nations. *See Report and Resolutions Submitted By the Technical Experts to the Financial Committee of the League of Nations on Double Taxation*

To accomplish this goal, the model treaties restricted the scope of activities that would create a permanent establishment for the MNE group members.[129] Concessionary withholding rates for royalties were advocated so that residual profits would escape source country withholding taxes.[130] Finally, and critical for our purposes, the League of Nations advocated the use of One-Sided Transfer Pricing Methodologies with the source country entity isolated as the tested party.[131] Accordingly, the source country subsidiary would be

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and Tax Evasion, League of Nations Doc. 115.M.55 1925 II, 21 (1925) (asserting that the country of residence should be given primary jurisdiction over income but that the country of source should have a right to tax income from real property, agriculture, and from commercial and industrial undertakings).

129. The scope of taxation of commercial undertakings was subsequently reduced through a narrowing of the definition of a permanent establishment. *See Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.216M.85 1927 II (1927) (activities of independent agents excluded from definition of permanent establishment); *Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations Doc. C.562M.178 1928 II (1928) (ownership of affiliated entities was deleted from the definition of a permanent establishment); *Report Presented by the Fiscal Committee to the Council on the Fourth Session of the Committee*, League of Nations Doc. C.399M.204 1933 II, 6 (1933) (adding explicit statement in the permanent establishment definition that the ownership of stock in a subsidiary would not by itself create a permanent establishment for the parent corporation in the source country); *Report Presented by the Fiscal Committee to the Council on the Fifth Session of the Committee*, League of Nations Doc. C.252M.124 1935 II.A, 3, Annex I at 6 (1935) (adopting, finally, restricted permanent establishment definition).

130. *Report of the Fiscal Committee to the League of Nations*, League of Nations Doc. C.340M.140 1930 II, 5–6 (1930); *Report of the Fiscal Committee to the League of Nations*, League of Nations Doc. C.415M.171 1931 II.A., 7 (1931) (adopting principles that royalties for patents should be taxed as industrial and commercial profits and therefore would not be subject to source country taxation if the foreign parent company did not have a PE in the source country); *Report Presented by the Fiscal Committee to the Council on the Fifth Session of the Committee*, League of Nations Doc. C.252M.124 1935 II.A. at 3, Annex I at 6 (1935) (final adoption of eliminating any withholding on royalties).

131. *See Report Presented by the Fiscal Committee to the Council on the Fourth Session of the Committee*, League of Nations Doc. C.399M.204 1933 II at 2 (June 26, 1933) (sets forth principle that the source country affiliate should be treated as an independent enterprise on basis of separate accounts and not share in residual profits); Mitchell B. Carroll, *Methods of Allocating Taxable Income, Taxation of Foreign and National Enterprises Vol. IV*, League of Nations Doc. C.425(b)M.217(b) 1933 II.A. at 45–47 (1933) (explaining that the method of separate accounts in terms we now understand to be One-Sided Transfer Pricing Methodologies, and that as long as the parent entity entered into intercompany transactions under the same circumstances and conditions and on the same terms as

entitled to the profits that an independent company performing the same functions would have earned and not share in the residual profits arising from the synergy of the combined group of companies working together. The early framers knew what they were doing.[132] They wanted residual profits to be stripped out of source countries without the need for explanation by making source countries the sole "tested party."

Profit split methodologies were widely understood and utilized prior to the League of Nations efforts to change the international paradigm, but those paradigms were rejected based on the economic objectives of the capital exporting nations. There were objections and fierce debates over whether source countries should allow residual profit stripping via One-Sided Transfer Pricing Methodologies or whether profit-split methodologies should instead be used, but these objections were ignored.[133]

Once the original intention of our current model treaties and transfer pricing methodology is understood, then the reason for the unwillingness to solve the HI/BEPS problem becomes apparent. It is because the original base eroders were the governments of developed nations in the post-World War I era. MNEs complied with that framework. After all, stripping profits out of source countries was the desired paradigm and MNEs have dutifully executed the paradigm's objectives.

D. Pillars of Base Erosion

It has been clear for a long time that One-Sided Transfer Pricing Methodologies and the model treaty paradigm are the root causes of the HI/BEPS problem. At least by 1951, the international business community had drawn this conclusion.[134] In a report issued that year, the International Chamber of Commerce noted that countries should draw their tax frontiers vis-a-vis foreigners so as to exempt services provided by non-residents via industrial knowledge, loans, purchasing goods for export, or sale of goods to

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they would be between two entirely independent persons, the tax authorities in general should respect the separate legal existence of the subsidiary company); *Report Presented by the Fiscal Committee to the Council on the Fifth Session of the Committee*, League of Nations Doc. C.252M.124 1935 II.A. at 3, 6 (1935) (final adoption of preference for One-Sided Transfer Pricing Methodologies).

132. It is a matter of great situational irony that MNEs have used this earning stripping paradigm that was put into place by the developed nations after World War I to base erode those same developed nations today. A cynic might think the developed nations find themselves hoisted on a petard of their own making.

133. *See* Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 549–66.

134. *See* INTERNATIONAL CHAMBER OF COMMERCE, "UNILATERAL RELIEF FROM DOUBLE TAXATION," (ICC STATEMENT AND REPORT OF THE COMMISSION ON TAXATION (1951).

the country in the absence of a PE. In addition, source countries should not inquire "into the total income of the non-residents."[135] The ICC also stated that "intermediary countries" should be treated as the country of residence and subsequent distributions of income to the ultimate resident country should not be subject to tax.[136] In essence, the ICC proposed that an intermediary country, even if it had no or a low effective tax rate, should be treated as the country of residence. This emboldened effort to obtain explicit protection for a low-taxed intermediate holding company structures demonstrates that planning in accordance with the 1920s paradigm had by the early 1950s become well understood and of significant importance to the business community.

In other words, base erosion had been institutionalized by the immediate post-World War II and Korean War periods. The pillars of such erosion were, and are, as follows under the OECD/UN model treaties:

1. Preference for residual income allocation to country of residence.
2. Treatment of interim holding companies as residence companies.
3. Minimization of the extent to which a foreign subsidiary could have a permanent establishment in a source country.
4. Preference for One-Sided Transfer Pricing Methodologies.

While the OECD and UN may be reluctant to acknowledge (via BEPS or otherwise) that these pillars of base erosion produced results consistent with the guiding principles of the founders of this model treaty and transfer pricing paradigm, such recognition is an important element for the process of finding an appropriate way forward for addressing the HI/BEPS problem.

IV. CURRENT MODELS FOR REFORM IN VOGUE

It is apparent that the principles that guide the structure of global taxation must evolve. The world has changed in dramatic ways since the existing framework was developed in the 1920s. With the political initiation of the BEPS process by the G-8 and G-20, it is apparent that there is governmental sanction for addressing the HI/BEPS problem.

The ultimate issue to be addressed, developed, and refined will be to find a solution. Hopefully, such a solution can achieve the objectives noted above, as well as attract global buy-in from all major participants. To date, there have been a variety of proposals put forward. Each of the principal

135. *See id.* at 2.
136. *See id.* at 10–11.

proposals is noted below with a tabular form of comparison with respect to achievement of the policy objectives noted at the beginning of this paper.[137]

A. OECD Has Just Begun BEPS

The OECD has just begun its formal work on this latest iteration of the HI/BEPS problem.[138] In February 2013, it issued a general statement of its intentions as follows:

> One of the underlying assumptions of the arm's length principle is that the more extensive the functions/assets/risks of one party to the transaction, the greater its expected remuneration will be and vice versa. This therefore creates an incentive to shift functions/assets/risks to where their returns are taxed more favorably. While it may be difficult to shift underlying functions, the risks and ownership of tangible and intangible assets may, by their very nature, be easier to shift.

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137. *See supra* Part I.

138. In the formative era where these decisions were being made, the homeless income problem was referred to under the umbrella of "fiscal fraud." *See Report Presented by the Fiscal Committee to the Council During Its Sixth Session of the Committee*, League of Nations Doc. C.450M.266 1936 II.A., 1, 4 (1937). The General Assembly directed the fiscal committee to study the problem of fiscal fraud and whether their newly released model treaty was creating this problem. The Fiscal Committee responded that fiscal fraud should be studied and handled by exchange of information and mutual cooperation among nations but that no significant changes to its model treaty were in order. The Fiscal Committee, in a statement that strikes one as very defensive, repeated its assertion again in the next year that any failure to fix the problem of tax evasion with respect to movable capital lies at the feet of member nations that would not adopt its farcical remedy. See *Report Presented by the Fiscal Committee to the Council During Its Eighth Session of the Committee*, League of Nations Doc. C.384M.229 1938 II.A., 1–2 (1938). The United Nations Ad Hoc Group of Experts would later comment that this discussion of international tax evasion was the last in depth discussion of tax evasion and avoidance in international forums until the 1970s. *See* Eighth Report of the Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries, U.N. Doc. ST/ESA/101, 7–8 (1980). One should not believe that these appeals to "exchange of information agreements" as the cure-all for the mistakes of using one-sided transfer pricing methodologies is a relic of the past; the OECD in its recent call for action on base erosion makes the same historical plea. *See* OECD, ADDRESSING BASE EROSION AND PROFIT SHIFTING, 10, 32–35, 42–43 (2013). The OECD in past times referred to the HI/BEPS problem as part of harmful tax competition. OECD, HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE, 13–14, 18, 70 (1998), http://www.oecd.org/tax/transparency/44430243.pdf [hereinafter OECD, HARMFUL TAX COMPETITION].

> Many corporate tax structures focus on allocating significant risks and hard-to-value intangibles to low-tax jurisdictions, where their returns may benefit from a favorable tax regime. Such arrangements may result in or contribute to BEPS. . . .
>
> Arrangements relating to risk shifting raise a number of difficult transfer pricing issues. At a fundamental level they raise the question of how risk is actually distributed among the members of a MNE group and whether transfer pricing rules should easily accept contractual allocations of risk. They also raise issues related to the level of economic substance required to respect contractual allocations of risk, including questions regarding the managerial capacity to control risks and the financial capacity to bear risks. Finally, the question arises as to whether any indemnification payment should be made when risk is shifted between group members.
>
> In summary, the Guidelines are perceived by some as putting too much emphasis on legal structures (as reflected, for example, in contractual risk allocations) rather than on the underlying reality of the economically integrated group, which may contribute to BEPS.[139]

These comments provide a 2013 synthesis of the problems created by the elements discussed above.

In July 2013, the OECD released its Action Plan (2013 Action Plan) for addressing the HI/BEPS problem over an approximate two year period.[140] The 2013 Action Plan reiterates many elements of the above quotation from February 2013. It appropriately notes that the current model treaty and transfer pricing guidelines date from the 1920s. As the world has become more integrated, those principles have allowed MNEs to identify and exploit legal arbitrage at various levels, including the domestic rules of respective countries, to achieve advantageous effective tax rate consequences including "double non-taxation" or less than single taxation.[141] The 2013 Action Plan

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139. OECD, ADDRESSING BEPS, *supra* note 26, at 42–43. To date in the BEPS process, the OECD has not acknowledged that the root cause of the HI/BEPS problem may be its own model treaty and transfer pricing guidelines, which provide the breeding ground for homeless income. Of course, in this regard, the OECD was the successor to the League of Nations. Such a relationship puts it in an ideal situation to update the underlying policies to reflect the international commercial, political, and fiscal realities of the current age.

140. *See* OECD, ADDRESSING BEPS, *supra* note 26, at 51–53.

141. See OECD, ACTION PLAN, *supra* note 26, at 8, 10.

identifies 15 subjects to be addressed, but it sets no clear direction or priority or organizing thesis for how to holistically address the HI/BEPS problem.[142]

For purposes of the present paper, the critical issues are the transfer pricing and treaty related matters. The 2013 Action Plan addresses the need for studying the categories of important issues noted above, but it provides an unweighted laundry list of action items that does not include a potential rebalancing of residence vs. source or the priority of source country ability to tax residual profits.[143] In its earlier February 2013 statement, the OECD

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142. The 2013 Action Plan's elements can be categorized as follows (with parenthetical references to the Action number designation assigned by the OECD):

1. Transfer Pricing Matters
   a. Intangibles transfer (Action 8)
   b. Risks and capital (Action 9)
   c. Non-third party arrangements (Action 10)
   d. Re-examine documentation (Action 13)
2. Treaty Matters
   a. Prevent treaty abuse (commissionaire-type arrangements) (Action 6)
   b. Prevent Artificial Avoidance of PE Status (PE Definition) (Action 7)
   c. More effective dispute resolution (Action 14)
   d. Develop multinational instrument to amend treaties (Action 15)
3. Backstop Matters
   a. Address the tax challenges of the digital economy (Action 1)
   b. Neutralize the effects of hybrid mismatch arrangements (Action 2)
   c. Strengthen CFC rules (Action 3)
   d. Limit base erosion via interest deductions and financial payments (Action 4)
   e. Counter harmful practices more effectively, taking into account transparency and substance (Action 5)
4. Information Exchange and Documentation
   a. Disclose rulings on preferential regimes (Action 5)
   b. Require disclose aggressive tax planning arrangements (Action 12)
   c. Collect and evaluate data about BEPS (Action 11)

See OECD, ACTION PLAN, *supra* note 26, at 14–24.

143. In fact, in the midst of stating that homeless income must stop at an OECD conference, Robert Stack, the U.S. Treasury Deputy Assistant Secretary (International Tax Affairs) advised that it was important that the BEPS project avoid reckless words like "the transfer pricing rules are broken." He then declared that "the [BEPS project is] not a project that is about a fundamental reexamination of residence and source country taxation," and that "[t]hat debate can happen at another place at another time." Kristen A. Parillo, *Days of Double Nontaxation Are Over, Stack Says*, 2013 TAX NOTES TODAY 107–05 (June 4, 2013). Unfortunately, the official was silent on when the international community ought to have such a debate. It is the authors' view that the debate is happening among non-OECD Member countries, led by the so-called BRICS. *See infra* Part IV.D.

asserted that base erosion is caused by "a large number of interacting factors,"[144] concluding that "there is no magic recipe to address BEPS issues."[145] Press reports from attendees and officials at OECD meetings suggest that no "radical change to international tax standards" is needed and "international tax rules work well in most cases."[146] One has the sense that the OECD has been here before and reached similar inconclusive results.[147]

Thus, at least as of the time of the writing of this article, it is fair to say that the OECD has not acknowledged that the root cause of the HI/BEPS problem is to be found in its own model treaty and transfer pricing guidelines (as successor, with the UN, to the League of Nations), which provided the pillars of base erosion.[148] Until such recognition occurs, any "solution" is not likely to be an effective means of achieving the pertinent tax policy objectives. One would hope that soon the OECD and others will frankly recognize the pillars of base erosion so that a consensus on a workable solution can be reached.

B. Status Quo

In evaluating solutions to the HI/BEPS problem, the starting point must be the status quo. Admittedly, the status quo is under significant attack, and there is hardly any voice which declares that it is the solution.[149] Nonetheless, an alternative paradigm must be more effective in achieving the

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144. OECD, ADDRESSING BEPS, *supra* note 26, at 51.

145. OECD, ADDRESSING BEPS, *supra* note 26, at 48.

146. Julie Martin, *Stakeholders Agree on Approach to Tackling Base Erosion and Profit Shifting*, 2013 TAX NOTES TODAY 67–69 (Apr. 8, 2013).

147. *See* OECD, HARMFUL TAX COMPETITION, *supra* note 138, at 18, 70; *see also* EUROPEAN COMMISSION, ANNEX: GROWTH FRIENDLY TAX POLICIES IN MEMBER STATES AND BETTER TAX COORDINATION IN THE EU, 10 (2011) http://ec.europa.eu/europe2020/pdf/ags2012_annex4_en.pdf. The commission stated that it

> believes that tax planning at firm level has become increasingly sophisticated in the past 15 years: instead of simply benefitting from preferential tax regimes of one country, some businesses engage in complex tax engineering whereby tax benefits are achieved through the imperfect alignment of tax systems of two or more countries. These developments have triggered a debate about the current and future role of the Code of Conduct Group. . . . In the current difficult times such loopholes, which also undermine the spirit of the Single Market, must be tackled.

Id.

148. *See supra* Part III.D.

149. *See supra* Part I.

tax policy objectives before the status quo should be trashed.[150] Thus, we evaluate each of the alternative proposals alongside the status quo in order to gain insight into the way forward.

C. Residence Country Global Taxation

There is a strong prevailing sentiment that the deferral of U.S. taxation of foreign subsidiary earnings creates an incentive for U.S. MNEs to invest in foreign locations in a scenario where the foreign affiliate manufactures and sells to the U.S. entity for resale in the United States market (the run-away plant problem). To overcome the perceived problems posed by such incentives (framed as an absence of horizontal equity between inbound and outbound investment), a significant group of scholars have proposed that all deferral provisions should be repealed in favor of global taxation of the earnings of U.S. MNEs, regardless of whether they earn income via foreign subsidiaries, foreign branches, or foreign permanent establishment structures.[151] Since 1962, Congress has made several attempts to achieve such results, but has enacted none.[152]

While Congress has never endorsed the full repeal of the deferral privilege, it has expanded the scope of the Subpart F regime when it believed that a stronger "backstop" was needed to prevent inappropriate income shifting.[153] The Obama administration[154] and important scholarly writings[155]

150. *Id.* A comparison of potential alternative structures is set out in Part IV. A comparison of these alternatives and our proposal is set out in Part V.

151. *See supra* note 35.

152. *See* Foreign Trade and Investment Act, H.R. 62, 93rd Cong. (1973); S. 2592, 92nd Cong. (1971); 122 CONG. REC. 21, 285–88 (1976); 121 CONG. REC. 7306, 7491–93 (1975); 120 CONG. REC. 39, 527–28 (1974). President Carter announced an intention to end deferral entirely in 1978. *See* Message from the President of the United States, Transmitting Proposals for Tax Reductions and Reform, H. R. DOC. NO. 95-283, 19 (1978). Democratic presidential candidate John Kerry also supported ending deferral in his election campaign in 2004. *See* Press Release, John Kerry for President, Fact Sheet on John Kerry's Plan to Create 10 Million Jobs (Mar. 26, 2004) (initially released on www.JohnKerry.com), http://app.vlex.com/#vid/fact-sheet-john-kerry-plan-million-jobs-192925655. Kerry's election platform tax plan sought to immediately tax all corporate income, whether earned domestically or internationally. *Id.*

153. *See* Michael Durst, *The Two Worlds of Transfer Pricing Policymaking*, 2011 TAX NOTES TODAY 16–22 (Jan. 25, 2011) (suggesting that backstop provisions of the Subpart F regime are the critical elements of combating U.S. tax base erosion); *see also* Wells, *"Territorial" Tax Reform*, *supra* note 14.

154. The Obama Administration's 2011 budget proposed to expand the scope of Subpart F to currently tax "excessive" returns from transfers of intangible property to "low-tax" jurisdictions. *See* STAFF OF JOINT COMM. ON TAXATION, 111TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE

have supported proposals to expand the scope of the Subpart F regime, but they have not gained legislative traction.

Notwithstanding such fortifications of the Subpart F backstop over the past 50 years, anxiety about base erosion has only escalated. Why? Because the Subpart F "backstop" does not address the pillars of base erosion.[156] As residency-centered solutions to the HI/BEPS problem continue to be evaluated, including the potential full repeal of the deferral privilege,[157] there are at least three realities that need to be addressed by a reform proposal advocated along these lines.

1. Failure to Address Inbound Erosion

Residency-based solutions (like subpart F reforms) that leave in place the preference for One-Sided Transfer Pricing Methodologies and then attempt to ring-fence the resulting transfer pricing mistakes are under-inclusive because such residency-based reform proposals only address U.S. MNEs in an ad hoc manner and entirely ignore the HI/BEPS strategies of non-U.S. MNEs. In reality, the HI/BEPS problem is equally present with both U.S. and non-U.S. MNEs.[158] Consequently, residency-based reforms that target U.S. MNEs and leave non-U.S. MNEs free to base-erode the United States creates incentives for U.S. MNEs to search for base erosion strategies, including inversions, or acquisition of U.S. MNEs by non-U.S. MNEs having such competitive advantage.[159]

PRESIDENT'S FISCAL YEAR 2011 BUDGET PROPOSAL, 252 (Comm. Print 2010), https://www.jct.gov/publications.html?func=startdown&id=3704. Treasury officials advise that the excessive return proposal does not conflict with U.S. transfer pricing or treaty obligations, since it is a Subpart F proposal, not a transfer pricing proposal, and provides a "backstop" to the existing transfer pricing rules. *See* David D. Stewart, *Excess Returns Proposals Don't Conflict with OECD Guidelines, U.S. Official Says*, 2010 WORLDWIDE TAX DAILY 207-1 (Oct. 27, 2010).

155. Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy, Part 2*, 136 TAX NOTES 1431 (Sep. 17, 2012); Edward D. Kleinbard, *Stateless Income's Challenge to Tax Policy*, 132 TAX NOTES 1021 (June 25, 2011) (Part 1); Edward D. Kleinbard, *The Lessons of Stateless Income*, 65 TAX L. REV. 99 (2011).

156. *See supra* Part III.D.

157. *See supra* notes 154.

158. *See supra* Part III.B.3.c.

159. *See* Bret Wells, *Inconvenient Truth*, *supra* note 12; Wells, *Corporate Inversions*, *supra* note 12; Mihir A. Desai & Dhammika Dharmapala, *Do Strong Fences Make Strong Neighbors?*, 63 NAT. TAX J. 723 (2010). Needless to say, a stream of income from successful international business has a much higher value to a MNE with a lower effective tax rate that the group owning the stream, regardless of the valuation method utilized (discounted cash flow, comparable analysis, or otherwise).

A U.S. tax system that allows enormous tax savings to MNEs depending upon the identity of the ultimate parent company and allows U.S. source income to become homeless income when earned by a non-U.S. MNE is not a viable solution for the HI/BEPS problem from an overall tax policy objective standpoint, as is noted below. Thus, even if residency-based reforms are well intentioned, their unequal application among the MNE community sows the seeds for inspiring reactive tax planning that ultimately erodes the efficacy of the original reform.

2. *Inconsistency With Trading Partners*

To further compound this point, Congress must recognize, as it obviously does, that residency-based reforms are out-of-step with the approaches taken by our major trading partners that have largely adopted territorial tax regimes.[160] As a result of the abandonment of worldwide residence-based taxation of MNEs by our major trading partners, the United States today stands virtually alone as the bulwark of this historic tax policy viewpoint.[161] Furthermore, because the country of residency is effectively a taxpayer election, many countries have acquiesced to such electivity and have created an international race to attract MNE headquarter companies via tax concessions.[162] As such, a reform proposal that is diametrically opposed to this global trend creates the risk of making the U.S. tax system uncompetitive.

3. *A "Second Best" Alternative Must be Found*

The ideal world envisioned in the 1920s—in which all countries adopt similar worldwide residency-based taxation regimes—never came to pass.[163] Indeed, virtually all countries which did embrace such policies have

160. *See infra* Part IV.D.

161. Thus, even if: (i) the paradigm of moving profits from source countries for the benefit of residency-based taxation is theoretically valid; and (ii) the Pareto optimum tax policy would be worldwide residency-based taxation of MNE activities, in a "second-best world" where all other countries reject residency-based policies augurs against a residency-based solution to the HI/BEPS problem in the "second-best world" that confronts us.

162. *See supra* notes 10–13.

163. It is one of the great ironies of tax history that the United Kingdom has now abandoned its worldwide taxation approach for MNEs. *See* PricewaterhouseCoopers, *News Analysis: PWC Reviews U.K. Finance Bill Provisions on foreign Profit Taxation*, 2009 WORLDWIDE TAX DAILY 87-22 (May 7, 2009). Thus, although Sir Josiah Stamp (the UK economic expert that participated in the 1923 Economic Expert Report) and Sir Percy Thomas (the UK tax expert on the UN Ad Hoc Group of Experts) predicted that other nations would eventually accept

in the interim abandoned them at least with respect to their taxation of MNE activities.[164]

Modern economic thought contains a guiding principle that is useful in such a context. Maximum economic efficiency for a society is termed the "Pareto optimum." The elements needed to achieve such a condition are known as the "Pareto optimum conditions." An inability to achieve Pareto optimum conditions causes a society to be unable to attain maximum economic efficiency.[165] In such a situation, society should seek a "second-best optimum." To do so, scholars have persuasively argued that second-best optimums require departure from the ideal policy paradigm.[166]

International tax policy debate has largely ignored the theory of second best. Instead, significant scholarly discussion has clung to the desire to promote the Pareto-optimum solution of worldwide residency-based taxation of MNEs (a first-best solution), even though the world is in a decidedly second-best position. The conclusion is poignant: even if the United States could unilaterally muster the political will to adopt a Pareto-optimum worldwide residency-based taxation of MNEs, to do so at this time is largely irrelevant because the world has moved away from the optimum condition (i.e., it is in second-best position). The United States exists in the world that it does—a world that has walked away from the optimal and requires the United States to rethink a second-best optimum solution that fits within the framework of the current reality.

In such a context, the theory of the "second-best" indicates that when a constraint is introduced into a general equilibrium system preventing attainment of a Paretian condition (i.e., worldwide consensus on residency-based taxation of MNEs), then the remaining Paretian condition (i.e., unilateral worldwide residency-based taxation of MNEs) is now no longer desirable to be achieved even if it were politically achievable.[167]

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worldwide residency-based taxation, the developed world, except for the United States, has largely rejected this grand experiment. *See* Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 548–51, 604.

164. *See* Wells & Lowell, *Tax Base Erosion and Homeless Income*, *supra* note 22, at 548–51.

165. *See* RICHARD S. MARKOVITS, TRUTH OR ECONOMICS: ON THE DEFINITION, PREDICTION, AND RELEVANCE OF ECONOMIC EFFICIENCY, 6 (2008) [hereinafter MARKOVITS, TRUTH OR ECONOMICS].

166. *See* R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11 (1956); MARKOVITS, TRUTH OR ECONOMICS, *supra* note 165.

167. For an analysis of this line of reasoning, see Richard S. Markovitz, *Two Distortion-Analysis Approaches to Economic Efficiency Analysis: A Third-Best-Economically-Efficient Response to the General Theory of Second Best* (Univ. of Texas Law School, Law and Econ. Research Paper No. 132, 2008), http://ssrn.com/abstract=1136162.

In other words, a country committed to worldwide residency-based taxation, as has been the US, is in need of a "second best" alternative if it is to successfully address the HI/BEPS problem and remain competitive with its trading partners because holding to a Pareto-optimum ideal of worldwide residency-based taxation is a sub-optimal policy response for a second-best world. Implementing such a reform without international consensus would serve to exacerbate the HI/BEPS problem by motivating MNEs to elect-out of such jurisdictions in favor of jurisdictions that do not impose residency-based taxation[168] and leaves entirely unaddressed the HI/BEPS problem in the non-U.S. MNE context.

D. Territorial Tax Regime

As the 112th Congress got underway in 2011, multinationals proposed a territorial system to coordinate with trading partners and eliminate what they perceived to be the anticompetitive U.S. tax system.[169] The House Budget Committee Chair introduced a "Path to Prosperity" with the declaration that "our tax code is a jalopy of the 20th Century...and is not making us pro-growth and is not creating jobs." In May 2011, the Ways and Means Chair indicated a willingness to consider a territorial regime.[170]

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168. *See* Mieko Nakabayashi & James Carter, *America Goes It Alone on High Corporate Taxes*, WALL ST. J., July 18, 2013, http://online.wsj.com/article/SB10001424127887324348504578606381626042740.html (stating that at least 484 U.S. firms, with a value of more than $43.6 billion, have been acquired by foreign interests this year alone). One factor in these acquisitions is the different ways in which nations impose corporate income taxes. Also, companies with significant foreign operations relocate to countries with lower tax rates and territorial tax structures. *Id*. This move-out effect also makes it easier for foreign interests to outbid U.S. interests when acquiring American companies. The United Nations' 2010 World Investment Report reckoned that between 2000 and 2009, cross-border mergers in which U.S. firms were acquired by foreign interests were valued 42% higher than foreign companies acquired by U.S. firms. Anti-inversion legislation is incapable of building a high enough fence to effectively stop this trend. *See supra* note 12.

169. *See* Heather M. Rothman, *Witness Urges Congress to Examine Move Toward Territorial Tax System*, DAILY TAX REP. (BNA), Jan. 21, 2011, at G-2.

170. *See* Christine Grimaldi, *Witnesses Tout Territorial System at Pro-Growth Tax Reform Hearing*, DAILY TAX REP. (BNA), Sept. 15, 2011, at G-3; Brett Ferguson & Jonathan Nicholson, *Camp Open to Territorial Tax System, But Says Many Issues Must Be Discussed*, DAILY TAX REP. (BNA), May 13, 2011, at G-6. In September 2011, the Ways and Means Committee held hearings on various elements of a territorial system, which was supported as a way of achieving American jobs growth and increasing living standards and global competitiveness. *See* Grimaldi, *Witnesses Tout Territorial, supra*, at G-3; Damian Paletta & John D. McKinnon, *Treasury Weighs New Tax Scheme*, WALL ST. J., Sept. 10, 2011, at A4. Similar

While a pure territorial regime on its face seems to reflect a policy of treating all MNEs in a competitively neutral manner, there are at least two material elements that should give the United States pause before seriously considering such an approach.

1. One-Sided Transfer Pricing

As noted above, perhaps the single largest contributor to the HI/BEPS problem is the prevalence of One-Sided Transfer Pricing Methodologies, which, by definition, prevents allocation of residual income. So long as a country must rely on One-Sided Transfer Pricing Methodologies and must grapple with the factual determination challenge to defend its tax base, there will always remain anxiety about whether the tax base is adequately protected.

In the territorial context, tax base anxiety would also arise from the inevitable tendency of MNEs to allocate global expense (especially headquarters and general and administrative expense) to the domestic source where it would likely have the most benefit from an effective tax rate standpoint. One-Sided Transfer Pricing Methodologies are not likely to address such a tendency.

2. Retention of Backstops

Because of such tax base anxiety, it can be anticipated that a country embracing a territorial regime will want to have backstops to assure that its tax base is protected. In this regard, the U.K. again provides an excellent illustration. Notwithstanding its embrace of territoriality, the U.K. has retained its CFC rules, which means it is anxious about the ability of transfer pricing to defend the domestic tax base against allocation of residual profit to other countries and the HI/BEPS problem. In this regard, it is not surprising that the U.K. has also recently enacted a general anti-avoidance principle (GAAR),[171] which provides the tax administration with broad authority to

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hearings were held in the Senate Finance Committee. STAFF OF JOINT COMM. ON TAXATION, 112TH CONG., PRESENT LAW AND ISSUES IN U.S. TAXATION OF CROSS-BORDER INCOME (Comm. Print 2011), https://www.jct.gov/publications.html?func=startdown&id=4355 (background analysis for the Senate hearings).

171. *See* Stephen Bouvier, *U.K. Treasury Unveils Moves Against Tax Avoidance with Plan to Study GAAR*, DAILY TAX REP. (BNA), Dec. 8, 2010, at I-1; Kristen A. Parillo, *HMRC Official Explains U.K. GAAR Proposal*, 2012 WORLDWIDE TAX DAILY 133-1 (July 11, 2012). A proposed GAAR rule has attracted significant criticism. *See* Lee A. Sheppard, *British Propose Toothless Antiavoidance Rule*, 2011 TAX NOTES TODAY 233–32 (Dec. 5, 2011); James J. Tobin, *Resorting to GAAR?*, 42 TAX MGM'T INT'L TAX J. (BNA) 100 (Feb. 8, 2013).

disallow transactions deemed not to have sufficient substance. Accordingly, a territorial system does not, standing alone, address the HI/BEPS problem.

E. Formulary Apportionment

Another reform proposal is to replace the arm's length standard of section 482 with a formulary apportionment methodology.[172] In essence, a formulary approach would prescribe factors to be used to allocate the combined income, such as the once prevailing three-factor formula used by many states: payroll, tangible assets, and sales. This would also be akin to a Two-Side Transfer Pricing Methodology approach, which reflects the manner in which complex competent authority cases are often resolved.[173] Because formulary apportionment attempts to allocate residual profits in a systematic manner based on business factors, it has much to commend it in terms of a means of addressing the HI/BEPS problem.

However, formulary apportionment based on pre-set formulas has a number of draw-backs.[174] For example, the pre-set factors can be manipulated by reactive tax planning. As a result, states with formulary apportionment regimes needed to adopt anti-avoidance rules[175] that allow

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172. *See* Reuven S. Avi-Yonah & Ilan Benshalom, *Formulary Apportionment: Myths and Prospects*, 2 WORLD TAX J. 371 (2011); Ilan Benshalom, *Taxing the Financial Income of Multinational Enterprises by Employing a Hybrid Formulary and Arm's Length Allocation Method*, 28 VA. TAX REV. 619 (2009); *see also* Avi-Yonah, Clausing & Durst, *Business Profits for Tax Purposes*, *supra* note 32; *Transfer Pricing Issues: Hearing Before the H. Comm. on Ways & Means*, 111th Cong. 8–10 (2010) (statement of Martin A. Sullivan, economist); *but see* Rosanne Altshuler & Harry Grubert, *Formulary Apportionment: Is It Better than the Current System and Are There Better Alternatives?*, 63 NAT'L TAX J. 1145, 1166–67 (2010); JANE G. GRAVELLE, CONG. RESEARCH SERV., REFORM OF U.S. INTERNATIONAL TAXATION: ALTERNATIVES 13 (2010), http://assets.opencrs.com/rpts/RL34115_20101217.pdf (transfer pricing rules would become more important in a territorial system); James R. Hines Jr., *Income Misdistribution Under Formula Apportionment*, 54 EUR. ECON. REV. 108, 117–18 (2010) (focusing on the proposed EU community consolidated tax proposal with such allocation among countries; allocation factors often used do not reflect how business income is generated).

173. *See* Avi-Yonah, Clausing & Durst, *Business Profits for Tax Purposes*, *supra* note 32, at 510–23.

174. *See supra* note 32 (analysis of the challenges to formulary apportionment).

175. In the state tax context, throwback rules reassign (or ''throw back'') receipts from sales of tangible personal property from the destination state, when the taxpayer is not taxable there, to the state from which the goods were shipped, where the taxpayer is taxable. A "throwout rule" eliminates (or ''throws out'') from both the numerator and the denominator of the sales factor the receipts that would ordinarily be assigned to states in which the taxpayer is not taxable. A "throw-

adjustment of the functional activities that create the residual profits. Furthermore, state revenue departments and taxpayers must grapple with the question of which "factor planning" is distortive and which "factor planning" is inherent in the business.[176] In other words, state experience demonstrates that even formulary apportionment regimes require a facts and circumstances approach to work appropriately.[177] Once one believes that a functional analysis is needed to determine which factors should be considered in order to perform a profit allocation, then one is very close to supporting a two-sided transfer pricing methodology contemplated under Regulations section 1.482-6. Another factor to consider along these lines is that the OECD in its BEPS Action Plan has, in essence, categorically rejected formulary apportionment as a means of addressing the HI/BEPS problem[178] whereas the OECD has grudgingly accepted profit-split methodologies as an acceptable arm's length method.[179]

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around rule" distributes (or ''throws around'') receipts that would ordinarily be assigned to states in which the taxpayer is not taxable to all the states in which the taxpayer is taxable. The nuances of these distinctions are beyond the scope of this article, but are addressed by other scholars. *See, e.g.*, Walter Hellerstein, *Quest for Full 'Accountability' of Corporate Income*, 61 ST. TAX NOTES 627 (Sept. 5, 2011); Eugene F. Corrigan, *Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response*, 29 VAND. L. REV. 423, 430–431 (1976); William D. Dexter, *Taxation of Income From Intangibles of Multistate-Multinational Corporations*, 29 VAND. L. REV. 401, 406–07 (1976); William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 748 (1957). *See generally* Walter Hellerstein, *Construing the Uniform Division of Income for Tax Purposes Act: Reflections on the Illinois Supreme Court's Reading of the 'Throwback' Rule*, 45 U. CHI. L. REV. 768, 786–88 (1978). As has been pointed out by others, the European Commission's proposal is analogous to the "throw-around rule" posited in the state tax context. *See* Walter Hellerstein, *The Quest for Full Accountability of Corporate Income*, *supra*, at 638.

176. *See e.g.*, Statement of Decision, Microsoft Corp. v. California Franchise Tax Board, No. CGC08-471260 (Calif. Super. Ct. Feb. 17, 2011).

177. The Multistate Tax Commission announced in 2012 that it was considering a state transfer pricing model based on Section 482. *See Multistate Tax Commission Considering Section 482 State Model Regulation Project*, 21 TAX MGM'T TRANSFER PRICING REP. (BNA) 473 (Sept. 20, 2012). A suggestion that the factors need to be adapted to the facts and circumstances in question is close to our position that a two-sided transfer pricing methodology can be adapted to satisfactorily address the HI/BEPS problem. *See infra* Part V.

178. *See* OECD, ACTION PLAN, *supra* note 26, at 14.

179. OECD, ACTION PLAN, *supra* note 26, at 10. The OECD suggests the following for purposes of addressing what it describes as "high risk transactions," the OECD suggests that it will be appropriate to "[d]evelop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: . . .

F. Comprehensive Expense Disallowance

Another approach would be for the United States to disallow deductions for base erosion payments made to tax haven affiliates.[180] This is a source-country response to the HI/BEPS problem that addresses the problem at its source: related-party tax deductible payments charged from an offshore affiliate to an onshore affiliate. This makes for a commendable proposal.

For example, with respect to interest, the proposal would provide a more comprehensive approach to the limited earning stripping rules than exists under current law[181] and the limited reforms currently proposed by Congress.[182] However, the proposal makes the source country's tax jurisdiction over its share of the residual profits conditional on the tax rate of one or more other countries, and this solution leaves One-Sided Transfer Pricing Methodologies in place to be used. In this sense, it imperfectly protects the source-country's share of residual profits. In our minds, this order should be reversed. The source country should ensure that its share of the residual profits is taxed in all events. Furthermore, this proposal does not provide the IRS with access to the books and records of foreign affiliates so that it can determine the residual profits of the combined group. Consequently, an expense disallowance approach does not ensure protection of the source country's right to tax its share of the residual profits.

G. Comprehensive Gross Withholding Tax

Other scholars have proposed implementing a withholding tax on all deductible payments of U.S. payers, including payments to treaty or OECD countries, which would be refundable when the recipient showed that tax has

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(ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; . . ." *Id.* at 20.

180. *See* Michael Durst, *Statutory Protection for Developing Countries*, 2013 TAX NOTES TODAY 18–27 (Jan. 28, 2013).

181. In this regard, section 163(j)(2)(B)(i)(II) already limits deductions for certain interest that exceeds a specified amount of adjusted taxable income. However, existing section 163(j) applies only to certain interest that is paid to or guaranteed by a related person. *See* I.R.C. § 163(j)(3) (definition of disqualified interest).

182. H. WAYS AND MEANS COMM., 112TH CONG., 1ST SESS., TAX REFORM ACT OF 2011, TITLE III, § 301-14 (Oct. 26, 2011) (proposed draft); H. WAYS AND MEANS COMM., 112TH CONG., 1ST SESS., TECHNICAL EXPLANATION OF THE WAYS AND MEANS DISCUSSION DRAFT PROVISIONS TO ESTABLISH A PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME, I (Oct. 26, 2011), http://waysandmeans.house.gov/UploadedFiles/FINAL_TE_--_Ways_and_Means_ Participation_Exemption_Discussion_Draft.pdf.

been paid on such income in the country of residence.[183] This proposal attempts to deal with the base erosion problem by collecting an upfront withholding tax on the base erosion payment, but this withholding is a final tax only if the country of residency does not tax this income at a sufficient level. Consequently, like the comprehensive expense disallowance proposal, this proposal makes the source country's tax jurisdiction over its share of residual profits conditional on the tax rate of another country, and this solution similarly leaves One-Sided Transfer Pricing Methodologies in place to be used wherever base erosion gaps in the withholding regime are found. Thus, this reform proposal only imperfectly protects the source country's right to tax an appropriate share of residual profits of the MNE group.

H. *Achievement of the Policy Objectives?*

Each of the above proposals has its own intrinsic merits. The ultimate goal for evolution of an alternative structure for U.S. international taxation should be to achieve the tax policy objectives. For an alternative proposal to be worthy of selection to replace the status quo, there should be a predicate of confidence that it will more effectively achieve the tax policy objectives than the status quo and other alternatives.

In Figure 1, we compare these alternative reform proposals in terms of the tax policy objectives proposed in Part I:

Comparison of Alternative Structures
Figure #1

Alternative	**(1)** Defend US Tax Base	**(2)** Treaty Compliance	**(3)** Competitive Neutrality	**(4)** Tax Collection
Status Quo	X	√	X	X
Territorial Tax	X	√	√	X
Formulary Apportionment	X	X	√	X
End deferral	½	√	X	½
Expense Disallow.	X	X	X	X
Gross Withholding	X	√	X	√

183. *See* Reuven S. Avi-Yonah, *A Coordinated Withholding Tax on Deductible Payments*, 119 TAX NOTES 993, 995–96 (June 2, 2008).

As indicated in Figure 1, in our view, each of the reform proposals surveyed in the prior section fail to achieve all of the tax policy objectives. Given that none of these proposals achieves all of the objectives (and, in fact, several of them are deficient on a number of fronts), it is appropriate to consider whether another approach may provide better achievement of the objectives.

V. THE WAY FORWARD: TWO-SIDED TRANSFER PRICING METHODOLOGIES AND BASE PROTECTING SURTAX

The above discussion lays the foundation for what is defective about section 482,[184] how this defect was purposely created,[185] and how MNEs have undertaken their planning in accordance with the treaty and transfer pricing rules to create the HI/BEPS problem. Part IV addressed the reforms under current consideration. While there is much to commend each of these reforms, none would comprehensively address the pillars of base erosion.[186]

It is respectfully submitted that the learning in Part III paves a path for development of an effective solution to the HI/BEPS problem, which will achieve all of the tax policy objectives. In this regard, we submit that the following reform of section 482 can achieve each of the tax policy objectives:

Reform Proposal #1: Mandatory Two-Sided Transfer Pricing Methodology. In every context where section 482 is to be applied, the result must be confirmed by a two-sided transfer pricing methodology. To the extent that a one-sided transfer pricing methodology or a CSA create a disparity in outcome, then the arm's length standard would only be met when the transfer pricing result is harmonized with the result reached under the two-sided transfer pricing methodology.[187] In other words, a two-sided transfer pricing methodology is the "best method" for determining the allocation of residual profits within an MNE group in all events whether the MNE is a U.S. MNE or non-U.S. MNE.

Reform Proposal #2: Base Protecting Surtax. To provide a means of tax collection on residual profits of an MNE, change the audit incentives,[188] and promote transparency, a "base protecting surtax"[189] should

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184. See Part III.A.

185. See Part III. B. & C.

186. See Part III.D.

187. In the event that a specific default is desired, it would be appropriate to review the work of the ICC in the early 1920s, in which the functional allocation between the residence and source countries was subject to a profit split default of 50-50 in the event the countries could not agree on the allocation. *See* Wells & Lowell, *Treaty Policy in the 21st Century*, *supra* note 98, at 6, 17.

188. If Reform Proposal # 1 were embraced, then the combined income would already have been developed and submitted with the tax return. In the event the domestic tax authority wants to examine further, there would be a commitment to

be imposed on the gross amount of any tax deductible base erosion payment made to a foreign affiliate. In essence, this would be an estimated tax due on the U.S. affiliate's share of residual profits that are stripped by tax deductible related-party payments. If the MNE believes the surtax amount is excessive, it can seek a refund based on the application of a two-sided transfer pricing methodology accompanied by a disclosure of all of the combined books and records of the MNE so that the amount of residual profits and the functions that contributed to their creation can be factually determined.

Mandatory use of Two-Sided Transfer Pricing Methodologies ensures that residual profits will be allocated only to the functions that contribute significantly to their creation. Though the MNE and tax authority may disagree on the allocation, the dispute is resolved only if the taxpayer bears the burden of proof that a non-U.S. affiliate is entitled to a portion of the residual profit because it provided a proportional substantive functional contribution towards the creation of the nonroutine intangibles. If the taxpayer were not able to meet its burden of proof, then the residual profits would remain with the affiliate that is shown to have substantively contributed to the creation of the intangible that generated those residual profits. Nothing is left unexplained. No allocation is made that cannot be substantiated by an analysis of the functional activities that created those residual profits.

As important as the first reform proposal is, the fact remains that by itself it does not provide a mechanism for the efficient tax collection of U.S. taxes on residual profits nor does it promote by itself the transparent discovery of the amount of residual profits and the functions that created those residual profits (tax policy objective (4)). Under current section 482 law, the IRS must engage in an audit process often with a MNE that has reported only routine profits in the U.S. affiliate using a one-sided transfer pricing methodology. The taxpayer has little incentive to be transparent with respect to the amount of the combined income or to the suggestion that the parties should use a two-sided transfer pricing methodology. Furthermore, the IRS may have jurisdiction to seek the books and records of the foreign affiliate when the MNE is a U.S. MNE, but the discovery process is likely to

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provide the requisite information. Accordingly, the tradition of "hide the ball" examination practices would be altered.

189. Professor Reuven Avi-Yonah proposed implementing a withholding tax on all deductible payments of U.S. payers, including payments to treaty or OECD countries, which would be refundable when the recipient showed that tax has been reported in the country of residence. *See supra* note 183. The base protecting surtax is not a withholding tax on a foreign person, but the same need for efficient tax collection exists with respect to potential U.S. tax base erosion and Homeless Income. This point has been applied in some source countries. *See, e.g.*, Toula Murphy, *Qatar: Companies Required To Withhold on Payments to Firms Not Located in Countries*, DAILY TAX REP. (BNA), June 14, 2011, at I-2.

be more cumbersome when the IRS is seeking the books and records of a foreign affiliates of a non-U.S. MNE.[190]

In order to address this tax collectability concern, the second reform proposal advocates an upfront collection of a base protecting surtax as a means to create an incentive on the part of the MNE to be transparent and work with the IRS to determine the correct amount of tax that is due on the U.S. share of residual profits. Because current law allows base erosion payments to become homeless income with no upfront collection mechanism, the IRS is left in the unenviable position of trying to defend the U.S. tax base against a zero-sharing of the MNEs residual profits through costly and expensive audits where the IRS may have difficulty obtaining foreign books and records.

An upfront surtax and the mandatory use of Two-Sided Transfer Pricing Methodologies fundamentally change the paradigm for most taxpayers. In combination, the mandatory use of Two-Sided Transfer Pricing Methodologies coupled with the upfront collection of tax on the residual profits via a base protecting surtax prevents homeless income from arising, or U.S. base erosion from occurring, because tax is collected upfront on the gross amount of all tax deductible related-party base erosion payments and does not allow this upfront surtax to be refunded unless a two-sided transfer pricing methodology demonstrates that a refund is due. Furthermore, the IRS would still have audit jurisdiction to assess taxes above the base protecting surtax in situations where a two-sided transfer pricing methodology indicates that more tax on residual profits is due. In such an audit, the IRS would be able to employ its normal audit process bolstered by the procedural benefit that Two-Sided Transfer Pricing Methodologies are elevated to the status of the "best method." Thus, the IRS would no longer be hamstrung by the need to argue against the application of One-Sided Transfer Pricing Methodologies whenever residual profits exist.

When one considers the reform proposals advocated in this article in the context of the OECD's Action Plan, it becomes apparent that the proposed section 482 reforms would facilitate achievement of each of the respective elements of the Action Plan related to transfer pricing.[191] Figure #2 evaluates this reform proposal against the tax policy objectives set out in Part I in comparison with the other policy proposals currently being debated.

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190. Admittedly, the IRS could avail itself of information from bilateral treaty partners under exchange of information agreements with that other country, but such a process is often cumbersome and not all countries have signed such agreements.

191. See OECD, ACTION PLAN, *supra* note 26, at 20–24 (Action Items 8, 9, 10, and 13).

Comparison of Alternative Structures
Figure #2

Alternative	**(1)** Defend US Tax Base	**(2)** Treaty Compliance	**(3)** Competitive Neutrality	**(4)** Tax Collection
Status Quo	X	√	X	X
Territorial Tax	X	√	√	X
Formulary Apportionment	X	X	√	X
End deferral	½	√	X	½
Expense Disallow.	X	X	X	X
Gross Withholding	X	√	X	√
Section 482 Reform Proposal	√	√	√	√

As indicated in Figure #2, reform of section 482 along the lines advocated in this article provides a mechanism to meet all of the tax policy objectives. Although the well-publicized failings of section 482 have convinced Congress and the Treasury Department to look outside section 482 for a solution to the HI/BEPS problem, the reality is that fundamental reform of section 482 is the optimal solution for the second-best world that currently exists. At present, section 482 is deficient because it currently allows taxpayers to use One-Sided Transfer Pricing Methodologies and CSAs to avoid having profits allocated to the affiliates that create those residual profits. This transfer pricing mistake has spawned the HI/BEPS problem and has caused section 482 to be perceived as an unlikely place for solving the HI/BEPS problem.

On the other hand, reformation of section 482 along the lines advocated in this article corrects this mistake and does so in a manner that achieves the tax policy objectives. As such, Congress, MNEs, and policy-makers, all of whom have a shared interest in solving the HI/BEPS problem in a manner that achieves the tax policy objectives, should be able to support reform of section 482 along the lines advocated in this paper. Accordingly, we hope that such a consensus can now begin to form.