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Cognitive Capture, Parliamentary Parentheses, and the Rise of Fractional Apportionment

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ARTICLE

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ABSTRACT

This article responds to recent scholarship, and the recent work of the European Commission of the European Union, advocating the use of ''formula apportionment,'' or ''fractional apportionment,'' as opposed to the ''arm's-length'' method in allocating the tax base generated by transnational corporations (TNCs). Historically, the United States and the international community have used the arm's-length method.[1] This use came under severe criticism in the mid- and late-1980s. In response, in the mid-1990s the United States and the Organisation for Economic Co-operation and Development (OECD) reformed their approaches, the U.S. through changes in its regulations and the OECD through modification of its guidelines for Member States, although they retained the arm's-length method. In the intervening time, experience has shown that the changes have not ameliorated, and may have exacerbated, the problems these reforms were intended to address. This has led to scholarship on the ''great transfer pricing wars'' — the processes, from about 1985 to about 1995, by which the revisions were developed — and both scholarship and officialdom progress toward developing formula apportionment systems as an alternative to arm's-length. This recent scholarship underestimates the difficulty and misconstrues the nature of the commitment of national governments and TNCs to the arm's-length system, and these misconstructions may lead to recommendations for change not in keeping with the economic ideas that underlay the original critique of the arm's-length system.

This article reviews the scholarship detailing the history of the ''transfer pricing wars,'' finding that scholarship misleading and incomplete in a number of respects. In particular, the article suggests that the tenacity and longevity of the arm's-length system is a product of ''cognitive capture'' — a term coined in a presentation to the 2008 annual conference at Jackson Hole, Wyoming, held by the Board of Governors of the Federal Reserve System. ''Cognitive capture'' describes the tendency of regulatory and legislative officials to think exclusively in terms dictated by the private interests they are supposed to regulate and control — and the same tendency of academics with

[1] §482 of the U.S. Internal Revenue Code of 1986, as amended (the Code). All section (''§'') references are to the Code or the regulations thereunder unless otherwise indicated.

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regard to interests they are supposed to objectively evaluate. This kind of ''cognitive capture'' not only has affected the bodies that adopted the transfer pricing changes in the mid-1990s and the academic supporters of those changes, but influences the current advocates of fractional apportionment today to almost as great an extent — preventing understanding of the true dimensions of the longstanding controversy over transfer pricing. The transfer pricing controversy is described as part of an ongoing construction of the relationship between public institutions, on the one hand, and businesses and other private institutions, on the other, and changes wrought during the mid-1990s represented a Clinton Administration abandonment of ''Anglo-American'' forms of capitalism, as opposed to ''rhenish'' or continental brands. The transfer pricing controversy and the ongoing construction of private-public relationships are related to issues growing out of the 2007–08 ''financial crisis,'' and the introduction of fractional apportionment should be coordinated with the development of international approaches to financial regulation.

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Within the last four years, two serious proposals have been advanced for the actual adoption and implementation of ''formula apportionment'' as a means for dividing the corporate income tax base on an international level. The first, developed over a seven-year period between 2001 and 2008, and still in the process of deliberation, results from the work of a Task Force of the European Commission aimed at proposing and defining a combined comprehensive corporate tax base (CCCTB) for use by European Union (EU) countries using formula apportionment.[2] The second, set forth in a paper issued under the auspices of the Hamilton Project of the Brookings Institution,[3] proposes that the U.S. unilaterally adopt a ''profit split/formula apportionment'' system, based on sales as a single apportionment factor. The ideas of the Hamilton Project subsequently received the endorsement of Michael C. Durst, a former Director of the Internal Revenue Service's Advance Pricing Agreement (APA) Program,[4] drawing much attention throughout the international tax community because the APA Program, first adopted in 1991, was a major achievement to preserve the existing ''arm's-length'' system of allocating tax profits among nations for tax purposes.

In the last 50 years, there have been two cycles of development of standards in this area, both under the rubric of ''arm's-length.'' The first occurred during the 1960s, when the U.S. first articulated rules for implementing the standard. The second occurred from 1985 to 1995, at the close of which the standards inherited from the 1960s were revised — by U.S. regulations finalized in 1994 [5] and Guidelines issued by the Or-

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[2] *See* European Commission, ''Implementing the Community Programme for Improved Growth and Employment and the Enhanced Competitiveness of EU Business: Further Progress During 2006 and Next Steps Towards a Proposal on the Common Consolidated Corporate Tax Base (CCCTB),'' 7 *COM* (2007) 223 (5/2/07), available at *http://eur-lex.europa.euLexUriServ/site/en/com/2007com2007_0223en01.pdf.*

[3] Clausing & Avi-Yonah, ''Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment'' (Brookings Institution 2007). The document is available at 2007 *TNT* 114–38.

[4] Address of Michael C. Durst to the International Fiscal Association, *The President's International Tax Proposals in Historical and Economic Perspective* (5/21/09), available at 2009 *TNT* 108–19, and 123 *Tax Notes* 1269 (6/8/09) [hereinafter Durst Presentation]. Durst was chief of the APA division in the mid-1990s.

[5] The regulations were adopted in final form in T.D. 8552, 59 Fed. Reg. 34971 (7/8/94), substantially as had been promulgated as temporary regulations Jan. 21, 1993 (the second day of the Clinton Administration), T.D. 8470, 58 Fed. Reg. 5263. The temporary regulations were issued without notice and comment, and were simultaneously issued as proposed regulations (finalized in July 1994). The 1993 temporary regulations removed proposed regulations that had been issued Jan. 30, 1992. INTL-0372-88; INTL-0401-88, 57 Fed. Reg. 3571. The temporary and final regulations were made effective for taxable years beginning after Oct. 6, 1994, although taxpayers were given certain options to apply them retroactively.

The final regulations appear today, in amended form, as Regs. §1.482-1 (general rules); §1.482-2 (specific situations: loans, services, and use of tangible property, in the original regulations as issued in 1994, loans and use of tangible property now); §1.482-3 (transfer of tangible property); §1.482-4 (transfer and use of intangible property), §1.482-5 (comparable profit method); §1.482-6 (profit split method); §1.482-7T (cost sharing); and §1.482-8 (examples of ''best method'' rule). The significant changes made, particularly with respect to Regs. §§1.482-2 and 1.482-7T, and the addition of §1.482-9, are discussed presently.

This article within does not survey the details of the regulations or the OECD Guidelines; this, like the literature it surveys and to which it in part responds, concerns general policy, not rule details, and, like that literature, assumes some basic background in the general content of the rules. For a discussion of the details of the existing rules, *see* Langbein, ''Transfer Pricing and the Outsourcing Problem,'' 106 *Tax Notes* 1299 (3/14/05). However, a brief statement of what the existing regulations are, and whence they came, will be helpful.

The original regulations were in Regs. §§1.482-1 and 1.482-2. Section 1.482-1, like its successor, set forth general rules. Section 1.482-1 had five subsections, lettered (a) through (e), which dealt with five specific intercompany situations: (a) lending; (b) provision of services; (c) leasing of tangible property; (d) licensing *or* transfer of intangible property; and (e) transfer of tangible property. The fighting issues were always in Regs. §1.482-2(d) and (e), which set forth the methods for determining intercompany transfer prices (the ''comparable uncontrolled price'' (CUP) method; the ''resale price'' method, and the ''cost-plus'' method under those rules).

The 1994 revisions greatly expanded and complicated the general rules provisions, adding three new major concepts. The first was the ''best method'' rule. Under the 1968, there had been a defined priority of methods: CUP, resale price, cost-plus, and unspecified ''fourth methods'' when necessary. The ''best method'' rule abolished any fixed priority, in effect directing the use of the method for which the best data were available. The second was

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ganisation for Economic Co-operation and Development (OECD) in 1995 (hereinafter 1995 OECD Guidelines). The latter cycle involved quite bitter controversies, culminating in an explicit condemnation of formula apportionment by the OECD Guidelines.[6]

Fifteen years has now elapsed since the issuance of the OECD Guidelines, sufficient time for them and the counterpart revised regulations to be evaluated. The current exploration of formula apportionment reflects widespread and pronounced dissatisfaction with the Guidelines. In 2003, Mr. Durst co-authored a major article examining the experience with the Guidelines.[7] The article accomplished three major tasks. First, it detailed a history of what Durst has called the ''great transfer pricing wars'' of the 1985–95 period. Second, it explored certain conceptual discontinuities and anomalies in the regulations-Guidelines system adopted in the mid-1990s. Third, it elaborated on certain practical difficulties with experience under the revised rules, with suggestions for certain ''incremental'' reforms.

The suggested reforms, however, stopped short of calling for an outright rejection of the arm's-length system, reflecting, in part, continuing, widespread hostility to the idea of fractional apportionment.[8] This hesitation makes all the more striking Mr. Durst's re-

the ''arm's-length'' range and the third, complex rules for defining comparability.

As for the specific situations, the first three — lending, services, leasing — were not changed by the 1994 regulations, but essentially retained as Regs. §1.482(a)–(c), respectively. The ''tangible property'' rules, with the three methods set forth in the 1968 regulations, were moved from Regs. §1.482-2(e) to newly numbered Regs. §1.482-3, with significant modifications. The ''intangible property'' rules were moved from Regs. §1.482-2(d) to newly numbered Regs. §1.482-4, with still more significant modifications. Two new pricing methods were added: the comparable uncontrolled price method (Regs. §1.482-5); and the profit split method (Regs. §1.482-6). The OECD Guidelines call them ''profit methods,'' as opposed to the three methods derived from the 1968 regulations, which the Guidelines call ''transactional methods.'' The genesis of these new methods is discussed within. In addition, the new regulations added Regs. §1.482-7, governing ''cost sharing'' devices; and Regs. §1.482-8, giving examples of the ''best method'' rules.

The Bush Administration made significant revisions to the regulations, as noted within. In particular, the ''services'' rules, which were not revised in 1994, were subject to extensive revisions and moved from Regs. §1.482-2(b) to new Regs. §1.482-9, in regulations finalized in 2009. T.D. 9476, 74 Fed. Reg. 38830 (8/4/09). These regulations were promulgated as temporary regulations by T.D. 9278, 71 Fed. Reg. 44466 (8/4/06). At the same time these changes in the ''services'' regulations were made, the Administration made significant changes to Regs. §§1.482-1, -4, and -6.

In addition, in 2005, the Treasury issued a notice of proposed rulemaking to amend the cost-sharing rules on Aug. 29, 2005. 70 Fed. Reg. 51116. These rules, substantially amended, were promulgated as temporary regulations on Jan. 5, 2009, as T.D. 9441, 74 Fed. Reg. 340. The temporary regulations are set forth at Regs. §1.482-7T, and expire on Dec. 31, 2011. Regs. §1.482-7T(n). They are effective after Jan. 4, 2009. The prior regulations, effective until Jan. 4, 2009, appear at Regs. §1.482-7A.

The provisions of the 1968 regulations remain applicable to taxable years beginning on or before Apr. 21, 1993, and those that are not incorporated in the currently effective regulations appear at Regs. §§1.482-1A and 1.482-2A.

[6] 1995 OECD Guidelines at ¶¶3.58–3.74, pp. III-19 to III-24.

[7] Durst and Culbertson, ''Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today,'' 57 *Tax L. Rev.* 37 (2003) [hereinafter Durst & Culbertson].

[8] Even at that, Durst and Culbertson hedged. The article was published in 2003, two years after the European Commission had instituted the study of a CCCTB with formula apportionment. Durst and Culbertson quoted congressional testimony of the then-Assistant Secretary of the Treasury for Tax Policy, a statement by an OECD official about ''softening'' positions on the matter, and articles on the European Commission's emerging interest in formula apportionment. Referring to these, they issued this anticipatory hedge:

> In the relatively short time during which this Article was initially drafted, discussed in draft form in a seminar setting, and prepared for publication, it appears that political alignments have shifted in a way that may increase the likelihood of changes to transfer pricing rules that are more fundamental than those suggested in this Article. See notes 314–16 and accompanying text. Even if that is the case, however (and political predictions, it must be remembered, are hazardous), we hope that the analysis provided in this Article will assist in the design of whatever fundamental reforms are considered desirable.

Durst & Culbertson at 41 n.6.

One theme throughout this piece concerns the extraordinary timidity of practitioners to question arm's-length publicly, and the discrepancy between views they express in protected, confidential settings, and those they are willing to make in public. In this sense, Durst's recent statements do show considerable courage, however late in his day they may come. For instance, at a 1996 University of Miami conference, a highly regarded international tax practitioner who had been an international tax official at the time of the 1962 consideration of the adoption of amendments to §482, made the extraordinary statement that he and another official had assured Congress that the Treasury could accomplish administratively what the proposed statutory change would have achieved (namely, the adoption of a formulary system), and that in so doing, they ''lied'' — that was his word. In this context, the frequent recent discussion of arm's-length and formula apportionment constituting a ''continuum,'' and of the possibility of a ''mixed'' system employing both formula apportionment and arm's-length (*see, e.g.,* Sullivan, ''Economic Analysis: A Middle Path Between the Arm's Length and Formulary Methods,'' 2010 *TNT* 11-6 (1/14/10), should be approached with awareness of the true origin of that idea at the 2003 Chartres conference (discussed below) and the manner in which national governments and international organizations treated the idea after it was first expressed with *some* apparent official acquiescence, in the mid-1990s. Durst and Culbertson themselves observe that ''even nonspecialized personnel of the taxpayer'' have come to view practice under the new regulations as ''little more than wheel spinning,'' and quote one observer that ''[t]he new specialty of 'comparables experts' is a concrete example of economic waste.'' Durst & Culbertson at 113 & n.272, quoting Hamaekers, ''Arm's Length — How Long?'' in *International and Comparative Taxation, Essays in Honour of*

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cent expression of support for fractional apportionment — in Toronto at a meeting of the International Fiscal Association (IFA), a forum that could be expected to be quite hostile to the idea.

Durst followed the IFA presentation by co-authoring a paper detailing a statutory proposal for a formula apportion/profit split method to be proposed for adoption by Congress as a unilateral U.S. measure.[9] That paper linked the proposal in a number of respects to the history of the ''transfer pricing wars'' detailed the Durst-Culbertson.

In 1986, I published what has become a ''well known'' [10] article questioning the claims that ''arm's-length'' was an established international norm, and arguing that the standard was inherently unusable for the purpose of making international income allocations.[11] In 1991, I presented a paper arguing for a ''modified fractional apportionment'' system for international adoption to an annual tax policy conference at the University of Michigan.[12] Naturally, I was disappointed by the U.S.'s abandonment of any effort for serious reform in the early 1990s, and by the promulgation of a system representing only a minor change in 1994–96, and I now welcome the renewed interest in formula apportionment proposals.

Nevertheless, I believe there are flaws in both of the major proposals publicized in the last four years. Perhaps more important, I believe there are serious omissions and errors in the account of the ''transfer pricing wars'' set forth in Durst-Culbertson, and that these omissions not only bear important links to the flaws in the proposals set forth in the proposals of Avi-Yonah, Clausing, and Durst, but also bear the potential of distorting and undermining future consideration given to the entire question. Most important of all, I believe that the transfer pricing question is linked — in ways that have never been adequately explored — to larger questions of international economic policy, both historically and currently, involving the definition of the very relationships among national governments, international organizations, and private interest groups, including multinational firms and organizations representing them collectively.

In the wake of recent international financial and economic turmoil, I believe it of moment to explore the relationship of the longstanding, continuing, ongoing transfer pricing controversy to these larger policy concerns. This article is an effort to examine some of these considerations.

I. THE RISE OF FRACTIONAL APPORTIONMENT

The period immediately following World War II saw the emergence of the modern transnational corporation (TNC), and the two decades since the end of the Cold War have witnessed further development of TNCs, which has accompanied explosive growth in the volume of international trade. TNCs pose daunting challenges to the effort to impose and collect corporate income taxes by the nations in which the TNCs operate. The core of the challenge is the determination of which states have the right to tax the combined corporate income of a given TNC, and of what amounts should be allocated. Historically, this determination has been made by the construction of (ordinarily hypothetical) prices imputed to (also ordinarily hypothetical) ''transactions'' among the various components of the TNC. The prices so constructed are called ''transfer prices,'' and the subject of their determination is referred to as ''transfer pricing.''

Under U.S. law, transfer pricing is accomplished pursuant to authority conferred by §482 of the Code, a sparsely worded provision that confers authority on the Treasury to allocate items of income, deduction, gain, loss, or credit among related organizations in order to prevent evasion of taxes or to clearly reflect income. This brief provision is implemented by extensive and complex regulations.[13] The development of these regulations has come through two distinct historical events. The first was in the 1960s, after the Kennedy Administration and Congress first exhibited serious concern about the problem of taxing TNCs. This episode culminated in the issuance of the first set of comprehensive transfer pricing regulations in 1968.[14] The second was between the mid-1980s and mid-1990s, when congressional and administrative, and to some extent public, concern about the growth of international business, and about difficulties with the 1968 regulations, led to a major overhaul of the

Klaus Vogel 29, 44.

If professionals recognize their practice as ''waste,'' why are there so few specialists who will call for fundamental reform of the rules, and why does it take them so long to do so? And if there is a longstanding and serious discrepancy between what these practitioners say publicly and what they admit privately, how much credibility do *any* of their public statements have?

[9] Avi-Yonah, Clausing and Durst, ''Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,'' 9 *Fla. Tax Rev.* 497 (2009) [hereinafter A-YCD]. The authors describe their proposal as ''similar in significant respects to the current 'residual profit split' method of the U.S. transfer pricing regulations and the OECD Guidelines,'' 9 *Fla. Tax Rev.* at 498, and its title (a ''formula profit split''), which contrasts with that of the Hamilton Project paper (''formula apportionment''), appears expressly aimed at emphasizing the point. But the origin of idea of ''continuity'' between arm's-length and formula apportionment is poorly understood, as I show below, in ways which I think overestimate the extent to which that logical continuity bears potential for influencing the course of political events. *See* note 92 above and accompanying text.

[10] As described in Thomas, ''Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method,'' 14 *Berkeley J. Int'l L.* 99, 125 (1996).

[11] Langbein, ''The Unitary Method and the Myth of Arm's Length,'' 30 *Tax Notes* 625 (2/17/86) [hereinafter Langbein, *Unitary Method*].

[12] Langbein, ''A Modified Fractional Apportionment Proposal for Tax Transfer Pricing,'' *Tax Notes* 719 (2/10/92).

[13] Regs. §§1.482-1 to 1.482-9; 1.482-1A; 1.482-2A; 1.482-7A; 1.482-4T, 1.482-6T; 1.482-7T.

[14] The history of this period is detailed extensively in Langbein, *Unitary Method*, at 642–47, and Durst & Culbertson at 48–58.

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regulations in 1994. This is the period of the ''great transfer pricing wars'' to which Durst refers.

The OECD responded, in both interludes, to U.S. initiatives with the issuance of guidelines for tax administrations and multinational enterprises of OECD Member States. These guidelines have largely either followed, or been coordinated with, the conceptual approach of the U.S. regulations. The guidelines following the first (1968) regulations were issued in the form of a report in 1979.[15] Those corresponding to the 1994 regulations were apparently developed in conjunction with the U.S.'s development of the 1994 regulations.[16]

Throughout these developments, the U.S. and the OECD have professed fidelity to the principle that transfer pricing should be accomplished pursuant to the ''arm's-length'' standard. This standard holds that profit should be allocated by determining a ''transfer price'' between components of an integrated group that reflects the price that would be charged were those components separate enterprises dealing with each other at arm's length. This standard is often said to be the international norm for determining transfer prices.[17]

The process by which the 1995 U.S. regulations and the 1995–96 OECD Guidelines emerged constitute Durst's ''great transfer pricing wars,'' [18] instigated, apparently, by public challenges to the notion that transfer pricing should be accomplished according to the arm's-length standard.[19] The challenge was twofold, questioning first whether arm's-length was actually the ''norm'' and what kind of norm it was, and second whether — as a theoretical and a practical matter — arm's-length was an appropriate or workable rubric for the task assigned to it, whatever were established norms. The second point was the more important, and the more widely asserted. The U.S. government never publicly questioned whether arm's-length was the norm, but a 1988 ''White Paper'' paid considerable attention to outstanding commentary questioning the theoretical basis of the standard.[20]

The historically accepted alternative to arm's-length is so-called formula apportionment (sometimes ''fractional apportionment''), which proceeds by dividing the combined profit of a group according to criteria reflecting the relationship of the group or its members to the various states in question (tangible assets, payroll, sales in the various states, or other similar criteria). The use of this method by the American states in the decade preceding the ''transfer pricing wars'' provoked a prolonged controversy resulting in the virtually forced abandonment of the method.[21] During that time, formula apportionment also was viewed almost as a kind of offense, a recreant state practice.[22] During the ''wars,'' possibly as a result of the harsh criticism to which arm's-length was subjected, this began to change. Nevertheless, the OECD reports explicitly, if not stridently, rejected formula apportionment as a ''non-arm's-length'' method.[23]

A decade and a half have passed since the United States and its trading partners began to work under the new regulations, which a few years ago were subject to revisions that may have been more significant than commentators acknowledge.[24] The experience does not seem to confirm the conviction of arm's-length adherents that the standard could be made workable without discarding the standard's essential principle. Numerous commentators have expressed doubts about the workability or effectiveness of the regulations,[25] and there has been a veritable explosion of interest in, and exploration of the workability of, formula apportionment.[26] Some of the interest in formula apportionment has been expressed by commentators who were

[15] Organisation for Economic Co-operation and Development (OECD), Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1979).

[16] OECD Guidelines.

[17] *See* Regs. §1.482-1(b)(1); OECD Guidelines at ¶¶1.1–1.14, pp. I-6 to I-7. *See generally* Thomas, ''Customary International Law and State Taxation of Corporate Income: The Case for the Separate Accounting Method,'' 14 *Berkeley J. Int'l L.* 99, 125 (1996).

[18] Durst Presentation (''I need to stop our time machine briefly for a visit to the late 1980s and early 1990s, that tumultuous period which has come to be called the time of the 'great transfer pricing wars.' '').

[19] Langbein, *Unitary Method*; *see* Durst & Culbertson, at n.107.

[20] Notice 88-123, 1988-2 C.B. 458, 483 & nn. 194–95, citing Langbein, *Unitary Method*, at 625 (discussing ''continuum price problem,'' as described below).

[21] *See* Langbein, *Unitary Method* at 626, 673 & n.1.

[22] Durst & Culbertson, at 78.

[23] OECD Guidelines at ¶¶3.58–3.74, pp. III-19 to III-24. Cf. also the remarks of then Deputy Treasury Secretary Lawrence Summers, quoted and discussed below.

[24] *See* Langbein, ''Transfer Pricing and the Outsourcing Problem,'' 106 *Tax Notes* 1299 (3/14/05). On the particular changes, *see* note 4 above; their significance is discussed briefly at notes 116–20, 123–27 below.

[25] *See* Durst & Culbertson 40–41, 125–127; Brauner, ''Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes,'' 28 *Va. Tax Rev.* 79 (2008); Benshalom, ''Sourcing the 'Unsourceable': The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions,'' 26 *Va. Tax Rev.* 79 (2007); A-YDC.

[26] Durst Presentation; A-YCD; McLure, Jr., ''Harmonizing Corporate Income Taxes in the European Community: Rationale and Implications,'' in *Tax Policy and the Economy*; Weiner, ''Practical Aspects of Implementing Formula Apportionment in the European Union,'' 8 *Fla. Tax Rev.* 629 (2007); Roin, ''Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment,'' 61 *Tax L. Rev.* 169 (2008) (criticizing recent proposals to adopt formula apportionment). For a report on a January 2010 conference in which the question of a shift to formula apportionment was much on the minds of the participants, see Sullivan, ''Economic Analysis: A Middle Path Between the Arm's Length and Formulary Methods,'' 2010 *TNT* 11-6 (1/14/10). To these sources must be added the veritable treasure of the occasional contributions of *Tax Notes* contributing editors Lee Sheppard (who writes ''news analysis'') and Martin Sullivan (who writes ''economic analysis''), ordinarily both quite critical of the arm's-length standard, and, particularly in Sheppard's inimitable and patented way, caustic but breathtakingly accurate in

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active during the ''wars'' of the 1986–94 period — on the side of the adherents of arm's-length.[27] In May 2009, the Obama Administration issued a series of significant proposals to reform international tax rules.[28] These proposals did not include changes to the transfer pricing rules, but they stimulated discussion in which the central role of those rules, as well as abiding difficulties with the 1995 revisions, were highlighted. Most striking was Michael Durst's May 22, 2009, address to the IFA.

Professor Reuven Avi-Yonah, a consistent and articulate critic of arm's-length, recently commented that the difficulties with arm's-length are well-known and do not bear repeating.[29] This perhaps true in the context in which Professor Avi-Yonah is writing. But the 1995 regulations were a significant effort to resuscitate an ailing system; the experience under those regulations contributes to an understanding of what alternatives exist now and how they might be implemented, and continuing commentary has generated certain ideas in relation to the transfer pricing problem as it has developed under the regulations and guidelines that emerged in the mid-1990s. It is useful to revisit the original indictment made of the arm's-length standard, and to update and refine the ideas underlying that indictment in light of these various developments.

II. THREE PRELUDES TO THE ''TRANSFER PRICING WARS''

In approaching these questions, it is necessary to review the events of the ''great transfer pricing wars,'' which led to the current regulations/guidelines. But first it is important to emphasize three developments, or sets of developments, that immediately preceded the onset of the review of the arm's-length system. These developments played a significant role in what followed, but that role is routinely underestimated and possibly poorly understood by those commentators who have described the ensuing ''wars.''

A. The Attack on the States' Use of Fractional Apportionment

The first, as noted above, was the campaign — principally by foreign governments and enterprises but joined by U.S. enterprises — against the states' use of formulary systems. That campaign passed through four stages. First, the enterprises sought to ban formula apportionment through income tax conventions. A renegotiated convention with the United Kingdom signed in 1976 included a provision that would have prohibited the use of the system. This effort failed when the Senate refused to ratify that convention.[30] Second, the enterprises sought federal legislation that would have prohibited use of formula apportionment, but neither house of Congress showed even enough interest in such legislation ever to report any bill from any committee.[31] Third, the enterprises sought a judicial ruling that the use of the methods was an unconstitutional interference with the power of the federal government to speak with ''one voice'' in international affairs. The Supreme Court rejected this position in *Container Corp. v. Franchise Tax Board*.[32] Finally, the Reagan Administration convened a Working Group to forge a compromise between the state governments and business on the issue. The Working Group developed a compromise, implemented by 1986, under which the state governments would limit formula apportionment at the ''water's edge''; that is, they would apply it domestically but would not impose it on the worldwide operations of multinational enterprises.[33]

This controversy, like its successor, spanned about a decade; also like its successor, it generated extraordinary heat. One question is why the sides were as intense as they were. After all, what was involved was only state corporate income or franchise taxes the rates of which are not high when compared to those imposed at the federal level or by the national government of most of the U.S.'s major trading partners. But those involved understood that, especially for foreign multinationals, what was really at stake was what we now call ''transparency'': Formula apportionment, applied on a worldwide basis, required the collection and reporting of worldwide information about a consolidated enterprise to subnational authorities in the United States. And one such authority, the Franchise Tax Board of the State of California, was particularly nettlesome in this regard. Such reporting was costly,

taking aim at its many irrationalities. *E.g.,* Sheppard, ''News Analysis: Stress Testing Transfer Pricing,'' 122 *Tax Notes* 1187 (3/9/09); Sheppard, ''News Analysis: IFA Considers Transfer Pricing and Treaty Questions,'' 117 *Tax Notes* 305 (10/22/07); Sheppard, ''News Analysis: Practical Advice for the Section 482 Services Regs,'' 2006 *TNT* 239-6 (12/12/06); Sheppard, ''News Analysis: Revenge of the Source Countries, Part 6: Subsidiary as PE,'' 113 *Tax Notes* 210 (10/16/06); Sullivan, ''Economic Analysis: Transfer Pricing Costs U.S. at Least $28 Billion,'' 2010 *TNT* 54-3 (3/17/10); Sullivan, ''Economic Analysis: Half the Profits for None of the Work,'' 2005 *TNT* 176-8 (9/12/05). *Cf.* Sheppard, ''News Analysis: Banks' Foreign Tax Credit Arbitrage,'' 2006 *TNT* 137-4 (7/11/06).

[27] Durst Presentation; McLure, Jr., ''Harmonizing Corporate Income Taxes in the European Community: Rationale and Implications,'' in *Tax Policy and the Economy*.

[28] The release, ''Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives For Shifting Jobs Overseas,'' appears at 2009 *TNT* 84-44 (5/4/09). The 2010 budget made some revisions to these proposals, some reflecting concerns that pertain to transfer pricing; but the Administration (in *its* own patented way) has also signaled considerable ambivalence about whether it is serious about any of the proposals. See discussion of proposals by the U.S. government later in this article.

[29] Avi-Yonah, ''Xilinx and the Arm's Length Standard,'' *Tax Notes* 1231 (6/8/09).

[30] *See* 124 *Cong. Rec.* 18400, 19076 (1979). *See* Langbein, *Unitary Method* at 626, 673 & n.1.

[31] *See* Langbein, *Unitary Method* at 626, 673 & n.1.

[32] 463 U.S. 159 (1983).

[33] *See* Langbein, *Unitary Method* at 626, 673 & n.1.

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inconvenient, difficult, sometimes impossible; moreover, it might threaten the ability of enterprises to protect trade and other secrets that, as theory would ultimately demonstrate, are ordinarily at the core of the operation of multinationals.

B. Capital Export Neutrality and "Classification and Assignment"

The second pre-"war" development was a revision in general ideas about the international tax policy of the United States. Before the early 1980s, and especially beginning in the 1960s, the touchstone of that policy was thought to be "capital export neutrality" (CEN) — the notion that international tax policy should be structured to minimize its effect on incentives of persons subject to the jurisdiction of the taxing body on whether to invest domestically or abroad.[34] This was distinguished from other ideas such as "capital import neutrality" (miminizing the effect of taxation on whether capital was placed within the taxing jurisdiction or abroad) or "national neutrality" (minimizing the effect on incentives of the nation whose taxes were imposed on cross-border investments).[35] It was assumed that CEN had dominated international policy since such policy had begun to be seriously formulated in the period following World War I; an initial and influential academic survey early in that period to a considerable extent bore this assumption out.[36] And CEN was a dominant idea behind proposals first made by the Kennedy Administration to "end deferral," that is, to tax currently the income of the foreign subsidiaries of U.S. multinationals — proposals that sired the subpart F provisions and the first amplification of the "arm's-length" idea in the mid-1960s.

But beginning in 1980, especially with testimony given by then International Tax Counsel H. David Rosenbloom to the Oversight Subcommittee of the House Ways and Means Committee,[37] a review of international and U.S. treaty policy revealed that the dynamic actual policy, both of the U.S. and the international trading community, was not CEN, with its emphasis on the primary right of a "residence" state to tax, but a more complex "classification and assignment" system, which assigned a primary right to tax to the residence state with respect to *portfolio* income, but a primary right to the "source" state to tax certain more "local," less "motile," forms of income, from realty and active business. In ensuing years, this discovery would rather quickly become a "conventional wisdom," so much so that influential scholarly publications would mention it with little discussion.[38] But this change in the view of overall policy would greatly influence the course of transfer pricing policy.

C. The Marc Rich Prosecution

A third consequential development was a prosecution brought by the Justice Department in a highly visible transfer pricing case. In September 1983, the U.S. Attorney for the Southern District of New York

[34] *See* Bradford, U.S. Treasury Tax Policy Staff, *Blueprints for Basic Tax Reform* 89–90 (2d ed. 1984); U.S. Treasury Dep't, "Selected Tax Policy Implications of Global Electronic Commerce," *reprinted in BNA Daily Tax Rpt.* (11/22/96) at L-8; Joint Comm. on Tax'n, 106th Cong., *Overview of Present-Law Rules and Economic Issues in International Taxation* (Comm. Print 1999); Joint Comm. on Tax'n, 102d Cong., *Factors Affecting the International Competitiveness of the United States* 5 (Comm. Print 1991); "The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity" 383 (1985); Treasury Dep't, "Selected Tax Policy Implications of Global Electronic Commerce" 19 (1996); Inland Revenue, "Double Taxation Relief For Companies: A Discussion Paper" (1999) (UK Ministry of Finance), available at http://www.inlandrevenue.gov.uk/consult/dtrc.htm; Treasury Dep't., "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study" 23–54 (2000). *See generally* Graetz & O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke L. J.* 1021, 1033–35 (1997).

[35] *See generally* Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies," 54 *Tax L. Rev.* 261, 272–76 (2001).

[36] *Report on Double Taxation Submitted to the Financial Committee by Professors Bivens, Einaudi, Selligman, and Sir Josiah Stamp*, League of Nations Doc. E.F.S. 73 F. 19 (1923). This assumption is attacked in Graetz & O'Hear, "The 'Original Intent' of U.S. International Taxation," 46 *Duke L. J.* 1021, 1033–35 (1997).

[37] *Income Tax Treaties: Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means,* 96th Cong., 2d Sess. 57–88, 107–130 (4/29/80). The testimony is reprinted as Rosenbloom & Langbein, "United States Tax Treaty Policy: An Overview," 19 *Colum. J. of Transnat'l Law* 359 (1981).

[38] *See* Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification," 74 *Tex. L. Rev.* 1301, 1306 (1996) ("the ultimate goal underlying the international tax regime is that active business income should be taxed in the country in which it originates (the source country) and passive income should be taxed in the country in which the recipient of the income resides (the residence country)"); Warren, Jr., "Alternatives for International Corporate Tax Reform," 49 *Tax L. Rev.* 599, 599–600 ("The *conventional* division of the international income tax base . . . is that the source country has primary jurisdiction over corporate taxation, while the residence country has primary jurisdiction over investor taxation") (emphasis added); Ault, "Corporate Integration, Tax Treaties, and the Division of the International Tax Base: Principles and Practices," 47 *Tax L. Rev.* 565 (1992) ("[T]he League Report finally recommended the 'method of classification and assignment of sources' as the basis for bilateral tax treaties [under which] items of income were classified and then assigned to either the residence jurisdiction or the source jurisdiction. . . . [T]he right to tax business income, including the income of affiliated companies, was assigned to the source state. The right to tax income from business securities, however, was assigned exclusively to the residence state."). Both the Ault and Warren articles rely upon the Rosenbloom & Langbein article, primarily, and the Avi-Yonah article relies upon the Ault and Warren articles. Both Ault and Warren rely upon Ke, "International Double Taxation of Income: Relief Through International Agreement 1921-1945," 59 *Harv. L. Rev.* 73, 85 (1945), as well, although that article received little attention during the period between its writing and after the Rosenbloom testimony in 1980. Moreover, the Ke article, though it details the emergence of a "classification and assignment" system in the 1920s, is clearly, in its conclusion, on the side of the Seligman/CEN primacy view of optimum policy.

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indicted Marc Rich and Pincus Green, two prominent commodities traders, and two corporations controlled by them — Marc Rich + Co. AG, a Swiss corporation that did no business in the United States, and Marc Rich + Co. International, Inc., its wholly owned subsidiary, which was incorporated in Switzerland, but was engaged in a trading business in New York — on charges of tax evasion stemming from transactions during 1979 and 1980 in controlled oil, which on the surface appeared to have taken place entirely in Texas. The investigation leading to the indictments had already generated extensive and significant litigation concerning the government's power to compel the production of documents held offshore by the Swiss company.[39] Green and Rich were U.S. citizens who had been resident in New York but maintained offices in Zug, Switzerland. In April 1983, Rich and Green departed New York for Zug, and did not return to answer the indictment. The two corporations pleaded guilty to the charges in October 1984, and paid some $150 to $200 million in taxes, interest, and penalties.[40]

Rich and Green became wanted ''fugitives,'' and have remained abroad since. But a few years after the guilty plea, their counsel, who were different from the counsel who had represented them and the companies in connection with the original investigation and the guilty plea, presented to the prosecutors proposed findings of fact and conclusions of law authored by Professors Martin Ginsburg of Georgetown and Bernard Wolfman of Harvard, both highly respected tax scholars, which indicated that the transactions at issue did not generate taxable income to the corporations.[41] This was because the apparently Texas-based transactions were linked to offshore oil transactions; and the income from those transactions, though on the surface U.S.-source, was, when properly understood, foreign-source income, protected from U.S. taxation by the provisions of the (archaic) income tax convention with Switzerland in effect then (and still).

The prosecutors declined to respond to the entreaties of the new counsel and to credit the proffers of Professors Ginsburg and Wolfman, absent the return of the principals to face the charges. The impasse stood for over a decade, until, in the waning hours of his Administration, President Clinton entered a surprise pardon of Rich and Green, relying heavily upon the views of Professors Ginsburg and Wolfman. The pardon generated enormous public controversy, and both a congressional and a criminal investigation of the pardon and the former President. Ultimately, no charges were brought against the President or any other parties in connection with the pardon. But the entire episode served, at the beginning of the heated debate over transfer pricing, as a sample of the poison broth that could be brewed from the toxic ingredients of zealous government and arcane and highly indefinite transfer pricing laws.

A fourth set of developments can be treated as a prelude to ''war'': congressional enactments in the 1982–86 period. I recount these, rather, as an integral part of the 1985–95 developments, which I think follows the predominant practice of current literature.[42]

III. THE ONSET OF THE WARS

Current literature characteristically acknowledges[43] that the pre-1986 history of the transfer pricing rules is well documented in two studies, one by myself in 1986,[44] the other by Professor Avi-Yonah in 1995[45] (updated in 2006).[46] The article by Durst and Culbertson in 2003 included a review of the pre-1986 background, as well as a section on ''recent history,'' which recounted the 1985–95 history as well.[47]

A. Congressional Action, 1982–86

The changes wrought during the ''great transfer pricing wars,'' begin, as Durst and Culbertson recount, with congressional action in the early 1980s. The first such action was the enactment of §936(h) in the Tax Equity and Fiscal Responsibility Act of 1982.[48] Section 936(h) articulated ''profit split'' and ''cost sharing'' methods for imputing intangible income away from Puerto Rican subsidiaries (and those of other U.S. possessions) to U.S. parents. Durst and Culbertson call these ''a form of formulary apportionment,'' and, while this characterization might be controversial, the concepts are a core part of the compromises ultimately reached in the overall transfer pricing debate.[49] In 1984, in the Deficit Reduction Act, Congress adopted the ''superroyalty'' rule for ''out-

[39] *See In re Marc Rich + Co. A.G.*, 707 F.2d 663 (2d Cir. 1982), *cert. denied*, 463 U.S. 1215 (1983).

[40] *See* Lubasch, ''Marc Rich's Companies Plead Guilty,'' *New York Times* (10/12/84) p. D1; ''Biggest U.S. Tax Evasion Costs 200 Million Dollars / Fugitive Swiss Oil Trader Marc Rich and U.S. Lawyer Pincus Green Still Sought,'' *The Guardian (London)* (10/12/84).

[41] The conclusions of Professors Wolfman and Ginsburg were set forth in a set of detailed proposed Findings of Fact and Conclusions of Law proffered to the prosecution in 1990. The proposed Findings and Conclusions are set forth at 2001 *TNT* 36-34. They were made public subsequent to the controversial pardon of Rich and Green by President Clinton in January 2001.

[42] *E.g.,* Durst & Culbertson, at 61–64.

[43] *E.g.,* Durst and Culbertson, ''Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today,'' 57 *Tax L. Rev.* 37, 43 & n.8 (2003).

[44] Langbein, ''The Unitary Method and the Myth of Arm's Length,'' 30 *Tax Notes* 625 (2/17/86).

[45] 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).

[46] Avi-Yonah, ''The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation,'' 9 *Fin. and Tax Law Rev.* 310 (2006).

[47] Durst and Culbertson, ''Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today,'' 57 *Tax L. Rev.* 37, 43 & n.8 (2003).

[48] P.L. 97-248, §213.

[49] Durst & Culbertson, at 62. As indicated above and discussed

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bound'' transfers under §367,[50] and followed this in 1986 by adopting in the fabled Tax Reform Act of 1986 a comparable provision under §482.[51]

However, the development that triggered the ensuing events was not really the statutory enactments, but rather the language of the Committee Reports behind the 1986 Act. Durst and Culbertson recognize this, although they emphasize the language concerning congressional intent behind the superroyalty provisions.[52] This language, however, has not proved to play too decisive a role in subsequent developments, largely because, as most commentators have conceded, the manner in which the subsequent regulations were devised largely rendered both superroyalty provisions nugatory.[53] The key language was final language, first appearing in the Ways and Means Committee's report in November 1985, directing the Treasury to conduct a comprehensive study of intercompany pricing rules, in which ''careful consideration should be given to whether the existing regulations could be modified in any respect,'' and recognizing that there were ''serious other problems'' with arm's-length.[54] The language was repeated verbatim by the Conference Committee report issued in May 1986.[55]

B. *The Myth of Arm's-Length*: History

Shortly after the House Report was issued — a few months before the Conference Report was prepared and months before the conclusion of the Working Group recommendations for a ''water's edge'' solution to the ''problem'' of state formulary apportionment systems — I published *The Unitary Method and the Myth of Arm's-Length*, a two-part study of the arm's-length system. The first part was historical, and questioned the longstanding, widely repeated proposition — which I characterized as a ''myth'' — that arm's-length was some kind of universally recognized, international ''norm.'' The second was economic, and suggested that, in theory, arm's-length was defective, because organized multinational corporations do not behave ''as if'' they were a collection of unrelated organizations dealing with each other at ''arm's length.'' Both points, as articulated then, warrant brief restatement.

The historical part of the article began where David Rosenbloom's testimony, as well as his and my article had left off: just as the actual history of transfer pricing began where the subject of those earlier pieces had left off. The League of Nations evolved the ''classification of assignment'' principles throughout the 1920s and embodied them in the first ''model conventions,'' which were published in 1928. But they left one subject out, for the reasons I tell my students when I ask why the U.S. Constitution was drafted without mentioning whether the Federal Government would have the power to charter banks: not because the subject wasn't important enough to cover, but because it was *too* important. The allocation of profits of an integrated enterprise was subject to a subsequent study, over the period 1931–35,[56] culminating in publication of a separate convention, which represented the initial adoption of a ''separate enterprise'' or ''separate accounting'' standard over a ''formula allocation'' method.[57] The rules of that convention were integrated into two international model conventions of the League in the 1940s, and are carried forward in the later models of the OECD and United Nations.

1. Questioning the Status of the Norm

My 1986 article questioned both the impartiality of the 1931–35 studies, and their degree of realism as to the actual practices of states. It emphasized the largely undemocratic nature of the process that generated the supposed rules: the arm's-length system was ''nowhere statutory.'' [58] And the absence of enforcement of *any* rules in the wake of articulation of the principles: the taxation of international integrated enter-

more fully below, the idea of continuity between these methods, sanctioned by the mid-1990s compromises, and formula apportionment, has a longer history, and one with greater acquiescence by major governments and the OECD, than is commonly acknowledged. See also, in this regard, the remarks of Deputy Treasury Secretary Larry Summers at a Treasury conference on formula apportionment held in December 1996, discussed below.

[50] P.L. 98-369, §131. The ''superroyalty'' provisions demand that income attributed to the transferor of an intangible transferred abroad be ''commensurate with the income'' produced by the intangible. Thus, the ''superroyalty'' and the ''commensurate with income standard'' generally mean the same thing in the contexts of both §367 and §482.

[51] P.L. 99-514.

[52] Durst & Culbertson, at 63 & n. 93.

[53] Brauner, ''Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes,'' 28 *Va. Tax Rev.* 79, 95, 127 (2008). On the Service's search for the meaning of the term over two decades after the enactment of the provision, see ''IRS Trying to 'Come to Grips' with Commensurate with Income Standard, Official Says,'' 2007 *TNT* 107-7 (5/29/07) (statement of IRS Associate Chief Counsel (International) Steven Musher to an American Bar Association Section of Taxation meeting on May 11, 2007). The Associate Chief Counsel was discussing a Chief Counsel Memorandum, which appears at 2007 *TNT* 58-22 (3/23/07), apparently suggesting that the superroyalty provision does not permit ''retrospective'' adjustments; this concession as much as says the provision has very little if any significance.

[54] H.R. Rep. No. 99-426, at 424 (1985), reprinted in 1986-3 C.B. (vol. 2) 424.

[55] H.R. Conf. Rep. No. 99-841, at II-637, reprinted in 1986-3 C.B. (vol. 4) 637.

[56] Carroll, *Taxation of Foreign and National Enterprises (Volume IV) — Methods of Allocating Taxable Income*, League of Nations Document No. c.425(b).M.217(b).1933.11.A (9/30/33).

[57] Fiscal Committee — Reports to the Council on the Work of the Committee — Fifth Session, League of Nations Document No. C.252.M.124.1935.II.A (June 17, 1935).

[58] That situation has changed, at least since the reforms of the 1990s, if not since the OECD's adoption of the mid-1960s United States principles in the late 1970s. In the wake of these developments, some countries have enacted legislation embodying the principles of the OECD Guidelines.

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prises was a ''fiscal no man's land.''[59] The article then noted how this non-enforcement situation changed in the 1960s, with the proposals that led to the Revenue Act of 1962,[60] and the adoption of the first comprehensive regulations in 1968.[61] But it still questioned the ''norm status'' of arm's-length by noting that its acceptance by foreign nations was largely the result of an ''export campaign'' by Stanley Surrey, Assistant Treasury Secretary for Tax Policy under the Kennedy/Johnson Administration and before and later a Professor at Harvard Law School.[62] Moreover, when efforts were made to implement the system, the stated rules of the 1960s reform did not work, and tax officials more often than not had to resort to a ''profit split'' approach that resembled the fractional apportionment approaches that *had* been adopted legislatively (democratically) in *some* jurisdictions. Thus, the argument was that, even after articulation of the rules, the system was still undemocratic, on one level, and largely fictional, on another. And insofar as it degenerated in practice to a de facto fractional system, I described the ''norm status'' of fractional apportionment.

Professor Avi-Yonah's historical account is not at odds with this account, although it largely supplements it, rather than reinforces it. Professor Avi-Yonah's focus is on decisional law, and he tends to equate arm's-length with a system that relies upon comparables to determine intracorporate allocations. He shows that early decisions do not corroborate an equation of the statutory language of §482 and its predecessors with the search for ''comparables'' which he believes the regulations fasten to the ''arm's-length standard.'' But he then shows how, especially in the wake of the adoption of the 1968 regulations, the comparability idea begins to take over the judicial approach; and then demonstrates that, in the wake of *that* development, the decisional law becomes a series of ''disasters'' for the IRS. This largely corroborates: (1) that at its foundation arm's-length is an idea imposed from without the democratic process; and (2) that it, with its comparability garb, was disutile and degenerative.

The Durst & Culbertson account is also in accord on the details, without any real emphasis, however, on what I am calling here (though I never used the word in 1986) the ''undemocratic'' quality of the standard. But Durst & Culbertson actually echo some of the observations of the 1986 piece. On the ''fiscal no man's land,'' they say, ''[a]s late as the early 1970's, virtually no legislation addressed the issue outside the United States, and 'many . . . countries frankly admitted a wholesale lack of experience with the entire problem.' ''[63] And they do recognize that the emphasis on ''comparables'' in the 1960s regulations ''might appear surprising'' in light of the nature of congressional action on the matter in 1961–1962.[64] On the degenerative property of the ''comparability'' system, they note, with respect to the reported cases, that ''[v]irtually none of these cases ultimately was decided by reference to comparables''; but rather by ''approximate determinations of the 'reasonable' returns to be earned . . . or 'reasonable' percentages by which different parties to controlled transactions might 'split' their combined profits.''[65]

2. The Question of the Origin of ''Arm's-Length''

But there are two elements in Durst & Culbertson's account of the pre-1985 history with which I take issue, and they do seem to influence not only the subsequent analysis in the article itself, but the subsequent development of policy proposals by Durst, at least, and others. The first concerns the origins of the use of the separate enterprise system, which I quote with added emphasis:

> The apparent lack of interest in international transfer pricing *may* reflect the relative difficulty that corporate management faced, until relatively recently, in pricing intragroup transactions on terms other than those dictated by the market even when they were inclined to do so. Prior to the second half of the 20th century, large multinational groups existed, but the transportation, communications, and data management technologies necessary to operate them in a centralized fashion was far less developed than it has become in more recent years. Managements of even the most forward-looking multinational groups *were compelled as a practical matter to leave pricing among different components of commonly owned groups to the same self-organizing and self-enforcing market mechanisms that determined pricing among entities that were not commonly controlled*. Thus, it *seems highly likely* that, even among the constituents of commonly controlled groups, market dynamics resulted in *natural self-enforcement of a situation tolerably corresponding to widely held notions of 'arm's-length.'*[66]

This is a description of historical propositions, and one would expect that it would be substantiated by historical reference. To it is appended a footnote, but the footnote simply elaborates the speculation, with a reference to an earlier, practical piece by Durst:

> The management of a multinational entity may have strong business reasons, entirely

[59] Langbein, *Unitary Method* at 643–43.

[60] Langbein, *Unitary Method* at 643–44.

[61] Langbein, *Unitary Method* at 644–45.

[62] Langbein, *Unitary Method* at 645–51.

[63] Durst & Culbertson, at 46 & n.28, quoting Langbein, *Unitary Method* at 640. As to Durst & Culbertson's statement, I guess I understand everything except the ''outside the United States.''

[64] Durst & Culbertson at 54.

[65] Durst & Culbertson at 59–60 (footnotes omitted).

[66] Durst & Culbertson at 47 (emphasis added).

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> unrelated to tax considerations, to price intragroup transactions at other than market prices. In order to do so, however, the group's management must have the ability to make and enforce pricing decisions designed to benefit the interests of the group as a whole, rather than the separate interests of the group's constituents. That is, management must have the practical ability to manage the group in an effectively centralized manner, rather than in effect to delegate the function of determining intragroup prices by permitting separate units to operate largely independently and thus regulate the group's internal affairs through market mechanisms. See generally Michael C. Durst, Management vs. Tax Accounting in Intercompany Transfer Pricing, 10 Tax Mgmt. Transfer Pricing Rep. 909 (Mar. 6, 2002).[67]

As I say, these passages are not substantiated in any way, and they are not insignificant. I do not believe there is any truth to these assertions; there is no evidence from the pre–World War II, or the pre-1960s postwar period, that there was any actual conformity between how ''management'' allocated profits and how they ''would have been'' allocated among unrelated parties. Paradoxically, even ironically, I think precisely the opposite may be true, at least insofar as Europe is concerned: *Unrelated* parties may have behaved like modern *integrated* enterprises, because interwar European business degenerated into a system of market division and price fixing even among formally disaggregated entities. This is the system that World War II destroyed, with the void filled at first by the rising multinationalization of primarily U.S. enterprises entering through direct investment.[68]

Moreover, this point has been repeated in other contexts, at least twice by Durst, and in the last instance joined by Professors Avi-Yonah and Clausing.[69] And I do think the point is of more than historical interest, because it minimizes the institutional conflicts the transfer pricing issue appears to embody and to present, and in doing so, it underlies other conclusions that point to policy suggestions, or conclusions, that may be harmful if not destructive. The point will be clearer later.

3. The Nature of the Disputes of the 1960s

The second questionable part of the Durst & Culbertson historical account concerns their description of the business community's position in relation to the congressional proposals of 1962, especially the House Report's proposal of a formula system. They note that ''[b]usiness groups reacted vehemently to the House proposals, pointing primarily to what they described as the bill's greatly excessive grant of discretionary authority to enforcement officials,'' [70] and proceed to quote industry representatives' objections based on ''inequities,'' ''hardships,'' ''endless disputes,'' ''bookkeeping requirements,'' and ''administrative problems.'' But they suggest ''that some of the resistance *might have* resulted from the perceived revenue implications of the House proposal,'' which ''did not disguise its view that the proposed formulary approach would provide the Service with tools that would permit more vigorous enforcement,'' and ''threatened to amount to a substantive tax increase on a wide range of U.S. businesses.'' [71]

Again, this is a historical statement, again expressed in a conditional tense, and again it is speculative. And again it reflects a question that abides with respect to transfer pricing: whether the fundamental issue really is revenue. The 1962 proposal may have ''threatened'' a tax increase, but it did not constitute one. Proposals, before and since, that have been much more clearly tax increases have engendered considerably less ''vehemence.'' Again the suggestion is that transparency, at least as much as tax burden, and potentially the general relationship between the polity, as defined by constitutional norms, and the reality of modern interest group power, are at least as great a concern as tax burden by the unshakable adherents of arm's-length.

C. *The Myth of Arm's-Length*: Theory

1. Coase/Williamson Organization Substitution Theory

The second part of the 1986 article was theoretical, and it has been by far the less controversial though probably more influential part. It proceeded from theoretical works of Ronald Coase, and later Oliver Williamson, both now winners of the Nobel Prize in Economics. Coase in 1937 postulated that there is a

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[67] Durst & Culbertson at 47 & n. 32.

[68] I realize I am here doing exactly what I say Culbertson/Durst did: making historical assertions without substantiation. I am also aware that I am in part corroborating those authors' point, to the extent I am suggesting that ''in the old days'' integrated and non-integrated were similar (just that ''in the old days'' competition was not what in retrospect it may be assumed to have been). But my point here is not to make detailed assertions about ancient history, only to reinforce the point that arm's-length not only does not have, but never had, any solid theoretical grounding. And I do think that point is important in formulating where one goes from here on transfer pricing issues.

[69] A-YDC at 503–04 & n.11; Durst Presentation, 123 *Tax Notes* at 1272. The discussion in A-YDC is preceded by a statement that ''[s]uch an approach might well have made sense eighty years ago, when the legislative language underlying today's arm's-length standard for income tax purposes was first developed.'' To this is attached footnote 11, citing my *Unitary Method* article, Professor Avi-Yohah's 2006 revision of his 1994 article; and the Durst & Culbertson article. There is nothing in the *Unitary Method* article, or anything else I have written (or thought) that suggests I believe that the arm's-length approach ever ''made sense'' in the sense Durst & Culbertson and A-YCD suggest, and I really do object to the citation.

[70] Durst & Culbertson at 50.

[71] Durst & Culbertson at 51 (emphasis added).

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process of substitution at the margin in the choice between markets and organization, and that the organization or form an economic context takes is shaped by this process.[72] Williamson elaborated on this with ideas such as information impactedness: a seller of an unknown technology cannot protect the value of its right if it discloses its nature to a potential developer; the potential developer cannot safely commit to the cost of development without the very information it is perilous for the seller to disclose. Hierarchical form resolves the dilemma; the context will call forth integrated organization, rather than a series of individuated contracts.[73]

2. Internalization Theory

The Coase/Williamson approach lay at the foundation of the ''internalization'' theory of the multinational corporation.[74] Multinationalization occurs because integrated organization ''economizes'' on ''transaction costs'': in the ''information impactedness'' example, the ''costs'' are the risks of information sharing without integrated control, which integrated control reduces if it does not eliminate. In particular, two forms of costs or risks are mitigated by multinationalization: what might be called ''appropriation'' risk; and what might be called ''debasement'' risk. Appropriation risk relates principally to what transfer pricing practitioners like to call ''manufacturing intangibles'': A protected or protectable process cannot be risklessly disclosed to a potential developer or distributor because of the risk of reverse engineering or other form of appropriation.[75] Debasement risk relates principally to what transfer pricing practitioners like to call ''marketing intangibles'': An entity with a valuable trade reputation must keep control of distributors or outlet to prevent them from using the name to promote cheaper or otherwise inferior products or services.[76]

Internalization theory predicts the predominant patterns one encounters in transfer pricing practices, and suggests the infirmity of arm's-length as an idea. First, the ''displacement'' theory at the root of Coase's description predicts the difficulty of finding ''comparables''; an economic context whose optimum form of organization is integration is unlikely to co-exist with any context organized by individuated contracts. Second, when one resorts to what I called in 1986 a ''single component method'' — the resale price and cost-plus methods, at the time, the comparable profits method now — one generates a ''continuum price'' problem. A relatively low price is the ''downstream'' (seller's) break-even price; while a relatively high price is the ''upstream'' (buyer's) price. So any price in between will bring both parties into the transaction, and one has an analytical basis for picking any price along that continuum, but no analytical basis for selecting among them.

Moreover, internalization theory predicts the central role ''intangible'' property is apt to play in transfer pricing disputes. Both appropriation and debasement risks relate to the existence of valuable ''intangibles.'' These ''intangibles,'' indeed, may not be property at all, in that they may not be severable from the total, integrated business within which they are used.[77]

The Coase/Williamson concepts were formulated, and first applied, in the context of antitrust law, to demonstrate the various forms, mostly of vertical, corporate integration were not necessarily harmful and should not necessarily be the target of antitrust enforcement. They also were applied to demonstrate that some forms of (mostly congolomerate) integration might be more harmful than otherwise supposed. But those concepts are applicable in the tax context to suggest that some way of accomplishing intercorporate allocations needs to be found that does not rely on useless arm's-length principles.

These economic arguments are, as Professor Avi-Yonah states, by now well enough known that they do not ordinarily warrant restatement. They have never been refuted; indeed, as a wide number of observers have frequently noted,[78] they have never even really been answered. But they do not solve the allocation problem for one reason, and they have not destroyed the arm's-length idea, for another. They do not solve the allocation problem because they do not convincingly suggest an alternative to arm's-length; they

[72] Coase, ''The Nature of the Firm,'' *reprinted in American Economic Association, Readings in Price Theory* 331 (G. Stigler & K. Boulding eds.) (1952). *See* Langbein, *Unitary Method* at 666–67.

[73] Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975). *See* Langbein, *Unitary Method* at 667–69.

[74] Buckley & Casson, *The Future of Multinational Enterprise* (1976); Dunning, ''Explaining Changing Patterns of International Production: In Defence of an Eclectic Theory,'' 41 *Oxford Bull. Econ. & Stat.* 269 (1979); Rugman, ''Internalization and Non-equity Forms of International Involvement,'' in *New Theories of the Multinational Enterprise* (Alan M. Rugman ed. 1981). The Buckley & Casson work is revised in Buckley & Casson, *The Multinational Enterprise Revisited: The Essential Buckley & Casson* (2010).

[75] *See* McManus, ''The Theory of the International Firm,'' in *The Multinational Firm and the Nation State* (Gillis Paquet ed. 1972) at 81–84; Langbein, ''Transaction Cost, Production Cost, and Tax Transfer Pricing,'' *Tax Notes* (9/18/89) at p. 1391, 1406 (discussing *Eli Lilly Co. v. Comr.*, 856 F.2d 855 (7th Cir. 1988)).

[76] *See* McManus, ''The Theory of the International Firm,'' in *The Multinational Firm and the Nation State* (Gillis Paquet ed. 1972) at 81–84; Langbein, ''Transaction Cost, Production Cost, and Tax Transfer Pricing,'' *Tax Notes* (9/18/89) at p. 1391, 1405–06.

[77] Langbein, ''Transaction Cost, Production Cost, and Tax Transfer Pricing,'' *Tax Notes* (9/18/89) at p. 1391, 1407–09.

[78] *See, e.g.,* Lepard, ''Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm's Length Standard as a Case Study,'' 10 *Duke J. Contemp. & Int'l Law* 43 (1999); Wickham & Kerester, ''New Directions Needed for Solution of the International Transfer Pricing Tax Puzzle: Internationally Agreed Rules or Tax Warfare?'' 56 *Tax Notes* 339, 348 (7/20/92); Kauder, ''The Unspecified Federal Tax Policy of Arm's Length: A Comment on the Continuing Vitality of Formulary Apportionment at the Federal Level,'' *Tax Notes* (8/23/93) at p. 1147.

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merely suggest that the comparability-based arm's-length idea is doomed. They have not destroyed the arm's-length idea, because, as I have stressed throughout, and as others have noted, the adherents of arm's-length are vehement and intransigent. Indeed, in the face of the elaboration of these ideas, that adherence can be properly, even calmly, characterized as mindless. And that mindlessness cannot be ascribed to concerns about revenue alone. Revenue, after all, is only money.

IV. COGNITIVE CAPTURE: THE BUITER PRESENTATION

The general reaction to the views expressed in the 1986 article — both the challenge to the status of arm's-length as an ''international norm,'' and the challenge to its economic rationality — can be seen as a species of what Willem Buiter, in a presentation to the 2008 Jackson Hole conference sponsored annually by the Board of Governors of the Federal Reserve System, called ''cognitive regulatory capture,'' or, more darkly, ''cognitive state capture.'' The notion is a refinement of longstanding notions of public choice theory of ''regulatory'' or ''state capture'' — the theory that because of the greater concern of regulated interests as opposed to the diffuse concern of the body politic at large, the regulated concerns come to dominate regulatory policy. The Buiter paper, presented in August 2008 — after the onset of the financial crisis, but immediately before it reached its zenith in September 2008 — was critical of Federal Reserve policy, with emphasis on two phases of policy. The first was the conduct of interest rate policy, especially in the 2007–08 period, which Buiter believed exhibited excessive concern for the impact of interest rate changes on asset prices, especially stock prices, with particularly harsh criticism for the ''panic cut'' intermeeting, on January 22, 2008; Buiter suggested there was reality to the notion of a ''Greenspan-Bernanke put.'' The second emphasis was bailouts by the Board, including the 1998 Long-Term Capital Management (LTCM) bailout and the more recent, much more dramatic March 2008 bailout of Bear Stearns, when, in Buiter's words, ''the Fed maximised moral hazard and adverse selection.'' Buiter suggested these bailouts occurred when ''obviously superior alternatives were available — and not just with the benefit of hindsight.'' [79]

His explanation was an idea he defined as ''cognitive capture'':

> I believe a key reason is that the Fed listens to Wall Street and believes what it hears; at any rate, the Fed acts as if it believes what Wall Street tells it. Wall Street tells the Fed about its pain, what its pain means for the economy at large and what the Fed ought to do about it. Wall Street's pain was great indeed — deservedly so in many cases. Wall Street engaged in special pleading by exaggerating the impact on the wider economy of the rapid deleveraging (contraction of the size of the balance sheets) that was taking place. Wall Street wanted large rate cuts fast to assist it in its solvency repairs, not just to improve its liquidity, and Wall Street wanted the provision of ample liquidity against overvalued collateral. Why did Wall Street get what it wanted?
>
> Throughout the 12 months of the crisis, it is difficult to avoid the impression that the Fed is too close to the financial markets and leading financial institutions, and too responsive to their special pleadings, to make the right decisions for the economy as a whole. Historically, the same behaviour has characterised the Greenspan Fed. It came as something of a surprise to me that the Bernanke Fed, if not quite a clone of the Greenspan Fed, displays the same excess sensitivity to Wall Street concerns.
>
> * * * *
>
> Both the 1998 LTCM and the January 21/22, 2008 episodes suggest that the Fed has been co-opted by Wall Street — that the Fed has effectively internalised the objectives, concerns, world view and fears of the financial community. This socialisation into a partial and often distorted perception of reality is unhealthy and dangerous.
>
> It can be called *cognitive regulatory capture (or cognitive state capture)*, because it is not achieved by special interests buying, blackmailing or bribing their way towards control of the legislature, the executive, or some important regulator or agency, like the Fed, but instead through those in charge of the relevant state entity *internalising, as if by osmosis, the objectives, interests and perception of reality of the vested interest they are meant to regulate and supervise in the public interest.*[80]

What is surprising is that this ''internalization,'' as if by process of osmosis, in the contemporary period,

[79] Buiter, *Central Banks and Financial Crises*, Discussion Paper No. 619, Sept. 2008, p. 104, available at http://moneynews.com/StreetTalk/marc-faber-gold-bernanke/2010/04/26/id/356860?s=al&promo_code=9CE9-1 (last visited Apr. 26, 2010).

[80] Buiter, *Central Banks and Financial Crises*, Discussion Paper No. 619, Sept. 2008, p. 107–09, available at http://moneynews.com/StreetTalk/marc-faber-gold-bernanke/2010/04/26/id/356860?s=al&promo_code=9CE9-1 (last visited Apr. 26, 2010) (emphasis added).

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and the period since the onset of the ‘‘transfer pricing wars,’’ not only afflicts the defenders of arm’s-length, within and without the governments of the various nations, but that it has a dominating influence on even the contemporary advocates of fractional apportionment. The influence is visible in a couple of instances cited above, in the recounting of the pre-1985 history: the emphasis on revenue, rather than transparency and general power relations, in explaining business opposition to the 1962 deferral/apportionment proposals; the implication that in its origin arm’s-length bore some degree of economic rationality in terms of how integrated organizations operated, as opposed to the function of arm’s-length as a means of encroaching on the domain of public institutions, which has been the real purpose of the principle all along.

This ‘‘cognitive capture’’ also seems to condition the account given of the ‘‘wars’’ of the 1985–95 period, when, as explained below, Durst & Culbertson in particular accept a characterization that emphasizes the more narrow and nationalistic aspects of the U.S. position, and minimizes the idealistic public policy orientation of the more patient and impartial critics of arm’s-length.

V. THE TREASURY WHITE PAPER AND ‘‘NET INCOME BENCHMARKING’’

In October 1988, the Treasury issued its ‘‘White Paper’’ on transfer pricing, its report in response to the mandate in the House and Conference Reports on the 1986 legislation.[81] The first part described background: the pre-1986 experience with transfer pricing; administrative problems; the problem of finding comparables; and the alternative ‘‘methods’’ developed in the case law. The second part discussed the 1986 statutory change, the ‘‘commensurate with income’’ standard, first generally, then in terms of compatibility with international standards; then the question of ‘‘periodic adjustments’’; and finally the question of safe harbors. The final part discussed alternatives and variations on arm’s-length. The first chapter in this part (Chapter 10 of the White Paper) discussed economic theories, with focus on critical arguments based on the nature of modern integrated enterprises. The second described, based on this analysis, a ‘‘basic arm’s-length return method’’ (BALRM), which basically foreshadowed the current comparable profits method (CPM) or transactional net profits method (TNPM), with what the White Paper characterized as a ‘‘profit split’’ addition. The final two chapters discussed cost sharing.

A. The White Paper Economic Analysis

Throughout, the White Paper claimed fidelity to the arm’s-length principle. Its chapter on the ‘‘commensurate with income’’ standard ‘‘concludes that the arm’s-length standard is the accepted international norm for making transfer pricing adjustments,’’ and ‘‘reaffirms that Congress intended the commensurate with income standard to be consistent with the arm’s-length standard, and that it will be so interpreted and applied by the Internal Revenue Service and the Treasury Department.’’ [82] Its chapter on theory ‘‘examines these arguments and concludes that the market-based arm’s-length standard remains the better theoretical allocation method.’’

But, as Durst and Culbertson note, there was considerable tension between these professions and the underlying analysis of the Paper: ‘‘the White Paper seems to reflect an understanding of the arm’s-length standard that departed radically from the conception that, at the time, was the basis of most peoples’ understanding of the phrase’’; ‘‘both the economic analysis presented in the White Paper, and the methods that the White Paper offered in reliance on this analysis, constituted a fundamental challenge to the notion that effective transfer pricing administration can be based primarily on reference to uncontrolled comparables’’;[83] ‘‘it is clear that BALRM represented an important conceptual shift from prior governmental formulations of the arm’s length standard . . . the first governmental effort to incorporate into transfer pricing rules the specific recognition of the behavior of integrated groups, and in particular to come to grips with the likelihood that transactional comparables often will not be available’’;[84] ‘‘even the partial economic analysis offered by the White Paper gave ample motivation to suggest what critics soon labeled as radical departures from the arm’s length standard as it previously had been conceived.’’ [85]

This question of labeling would persist: Professor Avi-Yonah later would relegate arm’s-length to the idea of strict reliance on comparables; he and others would talk of a continuum, with arm’s-length based exclusively on comparables at one end, and formula apportionment at the other.[86] The matter is an important one, as commitment to ‘‘arm’s-length’’ continues to be the touchstone of lingering opposition by business groups and some government officials, here and abroad, to considering more far-reaching reform of the transfer pricing system. But my focus here is on the Durst & Culbertson account of this history of these ‘‘wars,’’ and more particularly on how that account (and the underlying history) are shaping contemporary approaches to the problem. And it seems that the dialecticism of the ways the question of the White Paper’s approach is framed can obscure important details about what actually happened (and what the questions are today).

[81] *A Study of Intercompany Pricing Under Section 482 of the Code*, Notice 88-123, 1988-2 C.B. 458.

[82] *Id.* at 5–6.

[83] Durst & Culbertson at 66.

[84] Durst & Culbertson at 73.

[85] Durst & Culbertson at 69.

[86] Again, there are questions about the origins of this notion of a ‘‘continuum,’’ and about how persuasive it may ever be to communities who have listened little to logic in the past.

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B. Durst-Culbertson Interpretation and "Net Income Benchmarking"

Durst and Culbertson appear to view the White Paper's economic analysis, and the critique of arm's-length that such analysis at least partially accepts, as inextricably linked to what they say was the "heart" of the White Paper proposals, the BALRM, and a concept (or approach) they seem to regard as indistinguishable from BALRM, which they call "net income benchmarking." In fairness, Durst and Culbertson acknowledge that a reductionist association of BALRM and "net income benchmarking" was in part a product of developments that intervened between the White Paper and the issuance of the first U.S. proposed regulations in January 1992.[87] But they also seem to interpret the White Paper inaccurately, in ways that may be attributable to the subsequent developments more than to what the White Paper actually says.

Durst and Culbertson suggest that the White Paper's treatment of profit splits is "brief"; that "in conceptual format it is surprising"; that the "White Paper treats the profit split approach as mainly an extension of the limited-risk BALRM approach"; that the discussion is titled "Profit Split Addition to the Basic Arm's Length Return Method"; that the "the discussion begins by suggesting that profit split should apply only in unusual cases, when the more generally applicable BALRM approach does not prove sufficient"; and that "[b]y treating the profit split approach as a special case of the limited risk model, the White Paper would appear to have reversed the sequence of analysis that the White Paper's overall conception of commonly controlled groups would appear most naturally to suggest." They say that "[i]f one accepts the model of an integrated enterprise as a joint economic venture over which the different participants are essentially free to shape their mutual arrangements in any manner that seems most efficient," then "it is the profit split that suggests itself as the generally applicable model, with the one-sided paradigm of BALRM, in which all risks and entrepreneurial activity are contained in a central entity, as a special case."[88] It is true, too, that "the White Paper offered no particular method for dividing the residual income," and "described the problem as 'difficult.' "[89]

It is emphatically true that an emphasis on the BALRM over the profit split method would "reverse the sequence" of the "overall conception" offered by the critique of arm's-length, and equally true that the White Paper was painfully inexplicit in relying on "judgment" to effect a residual profit split.[90] But I am not sure that, at least in its original conception, the White Paper did in fact "reverse the sequence." For one thing, while the discussion of the "profit split" is brief, and is suggested as an "addition," the White Paper can be read as conceding that reliance on that method might be extensive, and even central to a revised transfer pricing system. As Durst and Culbertson concede, both the underlying critique of arm's-length, and the White Paper, conceded a continuing role for the use of comparables; similarly, the critique of arm's-length recognizes there are circumstances where an assignment of "marginal" profits to functional components will complete the pricing determination. But the critique of arm's-length also suggests that both these sets of cases will be easier cases — it is the truly difficult cases, involving the largest amounts of revenue, that will call for the use of a profit split. There is really nothing in the White Paper that is inconsistent with this position.

C. The Theoretical Critique of Arm's-Length and "Net Income Benchmarking"

There, rather, may be alternative explanations for the White Paper's apparent emphasis on BALRM over profit splits. There are two such explanations, and I think they are mutually exclusive, even incompatible with each other. On the one hand, because profit splits bear a much closer resemblance to fractional apportionment than does the "marginal" component-reform analysis, as subsequent literature has made ever clearer,[91] the White Paper may have been shy about suggesting profit splits as a central el-

[87] INTL-0372-88; INTL-0401-88, 57 Fed. Reg. 3571 (1/30/92).

[88] Durst & Culbertson at 73.

[89] Durst & Culbertson at 74.

[90] *See*, to the same effect, Langbein, "Transaction Cost, Production Cost, and Tax Transfer Pricing," *Tax Notes* (9/18/89) at p. 1391, 1413.

[91] A-YCD at 498 (Proposed formula apportionment "system is similar in significant respects to the current "residual profit split" method of the U.S. transfer pricing regulations and the OECD Guidelines, as well as to the current method that U.S. states use to allocate national income across states."); 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, 158–59 (1995). The notion of a "continuum" of arm's-length and formula apportionment is sometimes attributed to Professor Avi-Yonah's 1995 article, but its true source is a report of an invitational conference on transfer pricing held under OECD auspices at the Chateau Esclimont near Chartres, France, in July 2003. The passage is quoted by Professor Avi-Yonah, who notes that the meeting was attended by officials of the U.S. Treasury, United Kingdom Inland Revenue, the Fiscal Affairs Division of the OECD, and the Japanese National Tax Administration, although it was attended by private practitioners as well:

> [T]he arm's length principle and formulary apportionment should not be seen as polar extremes; rather, they should be viewed as part of a continuum of methods ranging from [CUP] to predetermined formulas. It is not clear where the arm's length principle ceases and formulary apportionment begins, and it is counterproductive and unimportant to attempt to apply labels to the methods.
>
> (Arnold and McDonnell, "Report on the Invitational Conference on Transfer Pricing; the Allocation of In-

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ement of transfer pricing reform. Alternatively, as many of the forces to which Durst and Culbertson attribute the ultimate emphasis on ''net income benchmarking'' may suggest were already at work at the time the White Paper was written, the emphasis on BALRM may have already reflected a plan to use transfer pricing reform to enforce a form of ''net income benchmarking.''

In any event, whether either of these explanations — or any other — holds, my point here is that there is a clear disjunction between the underlying critique of arm's-length and the notion of net income benchmarking. This point is quite important. Durst and Culbertson tend to obscure it in their subsequent discussion; in any event, they treat the subsequent development of the ''wars'' as largely a contest between arm's-length retention, on the one hand, and net income benchmarking, on the other. And even to the extent they do not so treat the issues, business and foreign governments have, with their attack on the proposed U.S. reforms.

This treatment is erroneous, however, because after the White Paper, the ''reform'' side of the ''wars'' proceeded along two separate tracks. The first, hesitantly pursued by the government, professed continuing allegiance to arm's-length, but in one form or another advanced net income benchmarking. The second became a largely academic enterprise of trying to move from theory to a concrete proposed revision of the system that would be both workable and that had a chance of worldwide adoption within a space of 10 years.

Durst and Culbertson describe three circumstances as leading to the resolution, or degeneration, of the White Paper position into one defending ''net income benchmarking.'' The first was the IRS's continuing defeats in the Tax Court in its effort to advance a ''contract manufacturing'' theory under existing regulations.[92] The second was the dispute over California's use of the unitary method, which Durst and Culbertson suggest ''contributed in an impressionistic way to an identification of formulary approaches with aggressive and arguably unfair governmental enforcement efforts,'' such that ''the word 'formulary' became something of a shibboleth.'' [93] The third — and by far the most important — was the ''expansion'' of ''the scope of political concern over transfer pricing enforcement . . . beyond its traditional focus on outbound migrations of business activities from the United States to situations involving the distribution of tangible products in the United States.'' The center of concern was with Japanese exporters, and a ''perceived . . . tendency of the U.S. distribution subsidiaries of foreign (often Japanese) manufacturers to earn persistently low levels of income, or losses, from their U.S. operations.'' [94]

This led to ''serious proposals for the imputation of minimum levels of taxable income for foreign-owned subsidiaries, in apparent contravention of international tax norms,'' and to ''a brief period of notoriety''

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come and Expenses Among Countries,'' *Tax Notes* (12/13/93) at p. 1377, 1381.)

Professor Avi-Yonah omits the paragraph preceding this in the Arnold/McConnell report, which, at the risk of violating the confidentiality commitments we as participants in the conference all made, I must emphasize was the most important passage in the entire report:

> [T]he arm's length principle and formulary apportionment should not be seen as polar extremes. Formulary apportionment has a bad reputation, *largely for political reasons*, and the group tried to get beyond the *labels and the mythology*. There *seemed to be a consensus* in favor of *encouraging* further research on formulary apportionment methods, especially with respect to their practical application. There was *some disagreement*, however, about whether *encouragement in the form of sponsorship from international organizations*, such as the *OECD*, was *necessary or appropriate*.
>
> (Arnold and McDonnell, ''Report on the Invitational Conference on Transfer Pricing; the Allocation of Income and Expenses Among Countries,'' *Tax Notes* (12/13/93) at p. 1377, 1381 (emphasis added).)

I cannot fault Professor Avi-Yonah for the quotation of the one passage and not the other; I believe I reviewed and commented on an earlier draft of the 1994 article without mentioning the point. However, in part I did not mention it because the proceedings on which Arnold and McDonnell reported were confidential. But the ascription of the ''continuum'' idea to Professor Avi-Yonah, and not to the invitational conference, in subsequent literature, is not a minor matter of according credit for a notion: rather, it is suggestive of some of the themes I am emphasizing throughout, and the quotation of the second passage underscores this.

For it is abundantly clear that there is overt contradiction between the conciliatory tone reached at the invitational conference, attended by OECD representatives and indeed held under OECD auspices, and the harsh language adopted in the Guidelines condemning formula apportionment. The sharp departure can be taken as a betrayal, especially given the pledge of confidentiality made by attendees at the conference, and the action of the OECD member governments in so betraying a sensible compromise can honestly be characterized as dictatorial.

The episode illumines both of the more general concepts I attempt to introduce in this paper. The persistent ascription of the idea to Professor Avi-Yonah is a form of ''cognitive capture'': It treats the idea as an original notion of an isolated academic, when in fact it was a consensus of experts that include government experts, and was tied to consensus about further study and strong support for *official* further study. And the hauteur of the OECD and its Member States in deep-sixing a carefully and patiently wrought agreement represents the ''rhenification'' of free enterprise at its worst.

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[92] *Sundstrand Corp. v. Comr.*, 96 T.C. 226 (1991); *Bauch & Lomb, Inc. v. Comr.*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991).

[93] Durst & Culbertson at 78.

[94] Durst & Culbertson at 78.

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for transfer pricing "in the general press as an issue in the 1992 U.S. presidential campaign."[95]

Moreover, according to Durst and Culbertson, the ultimate resolution of the "wars" indicated that some form of "net income benchmarking" — as opposed to articulation of a longer range, more general and theoretically sound approach — had become the objective of U.S. bargaining in connection with the issuance of the final U.S. regulations and the OECD Guidelines:

> The two documents [U.S. final regulations and OECD Guidelines] reflect a compromise between the United States and its trading partners. The OECD Guidelines acknowledged the acceptability of measures based on net as opposed to gross income. They did so however, based on the U.S.'s retreat from the broader implications of the White Paper's BALRM. That retreat took the form of the increasing deference in the regulations to notions of comparability.[96]

VI. THE DURST-CULBERTSON INTERPRETATION AND THE "TRANSFER PRICING WARS"

The ultimate question here concerns how the mid-1990s revisions have worked out, and what that says about the eventual or ultimate fate of arm's-length. Before turning to that question, I believe it worth mentioning, and surveying briefly, three facets of the "war" that I believe Durst and Culbertson do not address either adequately or correctly. All three matters exert continuing influence on the continuing debate.

A. Oversimplification of the Critique of Arm's-Length

The first area grows out of what I adverted to above: the oversimplification of equating the critique of arm's-length with the notion of net income benchmarking. More than three years elapsed between the issuance of the White Paper (October 1988) and the first U.S. proposed regulations (January 1992). During that time, academic critics of arm's-length were neither inert nor supportive of the half-hearted (or left-handed) embrace of that critique by the White Paper. In a 1989 paper — which was as widely ignored as the 1986 paper was celebrated — I sought to go beyond the naked proposition, articulated in the 1986 paper, other literature, and the White Paper, that the idea of economies of integration vitiated the arm's-length notion by inquiring into the precise nature of those economies and into what that nature might inform us as to the proper rules we might devise.

As suggested above, that paper largely concluded that there were two predominant kinds of "transaction costs" on which integration economizes. The first are "appropriation" risks, the "information impactedness" idea: a party with a valuable (usually technological) idea, which needed an "outlying" party to exploit in a foreign jurisdiction, cannot costlessly disclose the idea to the other party, because of the risk the latter will appropriate the idea. The "outlying" party, at the same time, cannot commit resources to exploiting the idea without being in a position to evaluate for itself the potential value of the idea. Integrated form permits the two parties to work together without suffering the first party to risk appropriation, or the second to risk waste or exploitation.

The second kind of risks on which integration economizes are "debasement" risks. A party with a valuable intangible (e.g., trade name) cannot risk "contracting" or "licensing" the name to an "outlying" party without the ability to control that party's use of the name, lest that party use the name in a way that enhances its own return, whether in the short or long run, at the expense of diminishing or destroying the value of the name universally.

These notions can be invoked in articulating notions of "where" income is earned, in possibly surprising ways, and ways that influence concepts of the right to tax. Where integration addresses "appropriation" risks, this analysis implies that some of the "income" earned in a "satellite" location belongs to a place of "origin." Suppose what is at issue is a valuable patent, developed in Country A and embedded in a product sold in Country B. The Country B component is integrated so that the value created by the Country A component is not wholly "appropriated" — the implication is that some of the "profit" apparently derived in Country B appropriately "belongs" to Country A. This is not a surprising conclusion, as it is the analysis that underlies the search for a "royalty" (or "superroyalty") for intangible property, imputing profit to a "home" country.

Where integration addresses "debasement" risks, the analysis is a bit subtler. In the appropriation context, integration minimizes the "take" of the component in the "host" or "satellite" country, but does not diminish the before-transaction-cost earnings: Integration simply ensures that the home country component gets its fair share. In the debasement context, the idea really is that, by debasing, the host country component could earn a greater before-transaction-cost return if it were not restrained by the home country component. But the home component restrains the take in order to protect the returns to the "intangible" (the reputation) worldwide. In other words, any given satellite or host country really should get some sort of fee from the home country and other satellite country components, to compensate for its relinquishment of the opportunity to debase.

This analysis forms some theoretical basis for a formula allocation regime, on the assumption that any precise estimation of the "deemed" payments due would be impossible. Where "appropriation" risks are at issue, a portion of the "residual" profit (owing to and protected by integration) should inure to the capital investment made by the components of the enter-

[95] Durst & Culbertson at 79.

[96] Durst & Culbertson at 88–89 (footnotes omitted).

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prise, mostly the home component. Where ''debasement'' risks are at issue, a portion of the residual profit should inure to the place or places where sales take place. In the former case, the return is the gain that in the absence of integration would be appropriated; in the latter, the return is the gain a debaser could earn but foregoes to protect the business reputation.

This might suggest a two-part regime, where the residual is allocated to the home country where ''production'' or ''manufacturing'' intangibles are involved, or are allocated on the basis of assets; where a ''marketing'' intangible is involved, the residual is allocated to satellite countries, or allocated entirely on the basis of sales. In a 1991 paper presented at the University of Michigan, I rejected any such idea in favor of a unified system where the residual is allocated 50% on the basis of assets and 50% on the basis of sales.[97] I have been consistently critical of the effort, suggested and promoted, if not mandated, by arm's-length, to ''comminute'' income of an integrated enterprise into income from identifiable items of intangible property. My sense is that the ''residual'' is more properly viewed, in Marshallian terms, as a return to organization itself. Indeed, in most high-profit situations, there will be a linked ''manufacturing'' intangible and ''marketing'' intangible (the Coca-Cola formula, and the Coca-Cola and Coke trademarks; the Lipitor drug and the trade name, etc.). Thus, it seems a unified formula, uniformly applied would best approximate the reality of ''economies of integration.''

But the existence of this scholarship and these ideas are not acknowledged in the Durst & Culbertson account of the ''transfer pricing wars.''

B. Arm's-Length and Comparable ''Arrangements''

1. The Profit Split and Cost Sharing Methods

This first matter I say Durst and Culbertson address poorly is one they virtually ignore; the second is one I feel they overemphasize. This concerns the possibility of reformulating arm's-length so that it is directed not so much as a search for ''transactions'' that were ''uncontrolled'' and ''comparable,'' but rather for intercompany ''arrangements'' that are ''uncontrolled'' and ''comparable.'' Durst & Culbertson refer to this in connection with their discussion of the drafting of the 1968 regulations, as to which they note a ''lack of reference to the notion of an agreement among commonly controlled entities,'' and suggest that may have reflected ''an understandable lack of familiarity with the behavior of commonly controlled entities which, in the mid-1960's, had made their way only recently into the economic literature.'' [98] They stress the point in their discussion of the White Paper, and that Paper's treatment of the profit split and cost sharing methods:

> Missing from the White Paper, however, are: (1) a discussion of the dramatic contrast between the cost sharing model and traditional conceptions of retrospective enforcement of transfer pricing rules by reference to comparables, (2) consideration of why cost sharing by 1988 had persisted in the body of U.S. transfer pricing law for more than 20 years, despite its lack of conformity with the approach followed elsewhere in the law, and (3) most importantly, any consideration of whether the cost sharing model might suggest ways in which the arm's length standard might be applied more satisfactorily.
>
> The White Paper's omission of such discussion is particularly unfortunate in light of the fact that cost sharing, unlike other approaches with arguably formulaic characteristics, generally had been a creature of the taxpayer community and was (and remains) popular. Moreover, although the tempers of many participants in the transfer pricing debate already had been substantially inflamed, the White Paper was written at a time when the debate had not yet rigidified into a pattern under which any approach not depending heavily on uncontrolled comparables was automatically viewed as an attempt at heightened U.S. enforcement and therefore seen by many with suspicion.[99]

This suggestion — that arm's-length may be redeemed by treating it as an evaluation of business forms rather than an ex post examination of transactions — appears with some frequency, almost always advanced by defenders of arm's-length. Indeed, it appears in skeleton form in the proposed and final regulations issued in the 1990s, and the OECD Guidelines, in the guise of the rule that ''comparability'' depends upon similarity of ''contractual form'' between the examined party and any proffered comparable, as well as in the notion of a ''comparable profit split'' method. Indeed, even my 1989 article considers the notion in connection with examining how substitution of different business organization forms occurs, and can generate rules for profit allocation.[100]

However, the suggestion ultimately fails. To be fair, even Durst and Culbertson do not offer it as a cure for what ails arm's-length; they lament principally that the idea was not advanced more thoughtfully by the White Paper or otherwise early in the 1986–95 debate on transfer pricing. The problem is a resurfacing of the problem of comparability: Just as market-contract forms are displaced by integrated organization, and

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[97] Langbein, ''A Modified Fractional Apportionment Proposal for Tax Transfer Pricing,'' *Tax Notes* (2/10/92) at pp. 719.

[98] Durst & Culbertson at 57.

[99] Durst & Culbertson at 75 (footnote omitted).

[100] Langbein, ''Transaction Cost, Production Cost, and Tax Transfer Pricing,'' *Tax Notes* (9/18/89) at p. 1391, 1411–12.

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the two appear in different settings, so too do intermediate forms (e.g., partnerships or alliances) respond to different market situations, and consequently a disaggregated ''alliance'' is likely to exist in settings in which full integration does not occur. It is true that the two devices that were elevated by the 1995 regulations and Guidelines (and suggested by the 1982 amendments to §936), the profit split and cost sharing methods, can be seen as measures that base prices on ''intermediate'' forms of business cooperation. But neither expressly or in operation depends as such on comparables. The comparable profit split method of the regulations, as I have argued elsewhere,[101] is almost never explicitly used, and really will never be applicable except where one of the other comparability-based methods is also available, and in those circumstances the other method will almost always be easier to employ.

2. Difficulties with Cost Sharing

Moreover, there are theoretical difficulties in citing those two methods as a defense of arm's-length against formulary alternatives. The cost sharing method is, it is true, popular with the taxpayer community; but that has been so largely because the method is subject to abuse, and extensive tax avoidance.[102] Changes to the regulations proposed in 2005[103] and promulgated as temporary regulations in early 2009 addressed some of the difficulties, and correspondingly reduced the popularity of the method.[104] Most particularly, the cost sharing method presents problems of ''buy-in'' arrangements that simply replicate many of the difficulties of the comparability-based methods.[105] The profit split method, by contrast, is widely used, though perhaps not so widely as a strict interpretation of the regulations and Guidelines governing the other methods would warrant. But its use does not, as intimated above, rest on analysis of quasi-integrated arrangements of ''comparable'' firms, but rather on a priori stipulation of criteria to be used in making the profit split. In this regard, it is, as Professor Avi-Yonah and others have frequently noted,[106] more akin to a formulary method than to any species of arm's-length.

C. The Question of Politics

The final matter that I believe Durst and Culbertson treat inadequately concerns the political ramifications of the 1985–95 dispute. Durst and Culbertson note that ''the scope of political concern over transfer pricing enforcement in the United States'' expanded ''beyond its traditional focus on outbound migrations of business activities from the United States to situations involving the distribution of tangible products in the United States,'' particularly the low rate of observed taxation of the profits of Japanese exporters of automobiles and electronic products to the United States. They note that ''[p]olitical concern with the allegedly low levels of income of U.S. subsidiaries of foreign companies became so substantial that legislators offered serious proposals for the imputation of minimum levels of taxable income for foreign-owned subsidiaries, in apparent contravention of international tax norms,'' and observe that the ''transfer pricing issue even enjoyed a brief period of notoriety in the general press as an issue in the 1992 U.S. presidential campaign.'' [107]

1. Transfer Pricing and the 1992 Presidential Campaign

The presence of the issue in the presidential campaign was not so brief. Transfer pricing first appeared as an issue in the general press in a front page article in the Sunday *New York Times* in February 1990.[108] In the presidential campaign, Governor Clinton repeatedly claimed that he could raise $45 billion from foreign companies in four years by strengthening transfer pricing rules; shortly before the election, the *Times* would characterize the proposal as ''one of the pillars of his plan to cut the Federal deficit,'' and ''central to his dispute with President Bush over whether a Clinton Administration would have to raise income taxes on middle-income voters.'' [109] A Nexis search of ''Clinton and foreign companies and 45 billion'' between May 1, 1992, and January 1, 1993, in the ''major newspapers'' file yielded 54 results. Transfer pricing was a major issue in the campaign, and a central promise of Governor Clinton.

2. Clinton Administration Abandonment of Campaign Promises

What happened after the election? Very swiftly, though not publicly, the incoming administration assured the business community that it intended no ''fundamental change,'' but rather reforms along the lines already proposed by the Bush Administration. That administration had been working with the OECD and other Member States with respect to their objections to the 1992 proposed regulations, which had convoluted provisions implementing ''net income benchmarking.'' There had been widespread belief that the Clinton proposals would have had to involve some move toward formulary methods; the incoming administration quickly quashed such an expectation.

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[101] Langbein, ''Transfer Pricing and the Outsourcing Problem,'' 106 *Tax Notes* 1299 (3/14/05).

[102] *See generally* Benshalom, ''Sourcing the 'Unsourceable': The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions,'' 26 *Va. Tax Rev.* 79 (2007).

[103] 70 Fed. Reg. 51116 (8/29/05).

[104] T.D. 9441, 74 Fed. Reg. 340 (1/5/09). The temporary regulations are set forth at Regs. §1.482-7T, and expire on Dec. 31, 2011. Regs. §1.482-7T(n). They are effective after Jan. 4, 2009. The prior regulations, effective until Jan. 4, 2009, appear at Regs. §1.482-7A.

[105] *See generally* Benshalom, ''Sourcing the 'Unsourceable': The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions,'' 26 *Va. Tax Rev.* 79 (2007).

[106] Durst & Culbertson at 78–79 (footnotes omitted).

[107] Durst & Culbertson at 79 & n.161.

[108] Pear, ''I.R.S. Investigating Foreign Companies for Tax Cheating,'' *New York Times* (2/18/90) at p. 1.

[109] Cushman, ''Clinton Seeks Taxes on Hidden Profits,'' *New York Times* (10/23/92) at p. 9.

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With it, too, it abandoned any hope — the realism of which even opponents of arm's-length had doubted all along — of raising anything close to $45 billion from foreign companies from transfer pricing enforcement.

3. Interest Group Theory and Two Species of Capitalism

i. "Parliamentary Parentheses"

This pivot did not stand in isolation. The Clinton Administration comprehensively embraced the "free trade" policies espoused by the Republican administrations of the 1980s, even though the Clinton campaign had questioned those policies, and distanced itself from them. But the Clinton campaign embraced these policies aggressively, even radically. And it did this by implicitly assuming a false antinomy that an understanding of the "transfer pricing wars" in general, and the White Paper in particular, does a great deal to illumine.

The antinomy is, of course, free trade versus protectionism, and, so cast, the outcome was foreordained: All respectable economic theory validates the virtues of free trade. The reductionism of the White Paper, and still more the 1992 proposed regulations, lent credence to subsuming the transfer pricing issue under the antinomy, because the "net income benchmarking" approach, and the minimum tax proposals to which it bore a strong relation, had a decidedly protectionist aspect.

But the true critique of arm's-length did not, as I have stressed here throughout, have that aspect. That critique, and the proposals it generated, were not based upon notions that foreign exporters were being undertaxed and thereby gaining competitive advantages over domestic producers that should be neutralized. That may have been the case, and if it was, it added to reasons to redesign or abandon arm's-length, but the critique of arm's-length was an effort to achieve fair and economically neutral taxation of cross border enterprise, on the assumption that the profits of such enterprises should be subject to income taxation.

ii. Anglo-American and German-Japanese Capitalism

Moreover, the tension between that critique (as distinguished from net income benchmarking) and the position of foreign governments and foreign business was real, but it was not reflective of a tension between free trade and protectionism. That tension more resembled a different antinomy, one articulated in contemporaneous sociology literature, between two forms of capitalism, one predominant in Anglo-American jurisdictions, the other in Central European jurisdictions and in Japan.[110] The former is more rule-based and formal; more open, publicly; drew sharper distinction between public institutions and private enterprise; and, especially in America, was decentralized and heavily dependent on local public institutions, and smaller, localized private business. The latter form,

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[110] The notion of two different forms of capitalism emerged from research by British interest group theorists in the early 1980s, which found that "between an earlier age of estatist interest that waned during the course of the late eighteenth century and an era of 'collective' or interest group rivalry that arose toward the end of the nineteenth century lay an interval of relative parliamentary insulation from the needs and pleas of the marketplace"; "[t]his era was the zenith of Bagehot's parliament and of his informed public opinion; to borrow a suggestive, if overdrawn image: the liberal parenthesis." Maier, " 'Fictitious Bonds . . . of Wealth and Law': On the Theory and Practice of Interest Representation," in *Organizing Interests in Western Europe: Pluralism, Corporatism, and the Transformation of Politics* 27 (Suzanne Berger ed., 1981). This concept of the "parliamentary parenthesis" conditioned these theorists, in the wake of the collapse of the Soviet Union in the late 1980s, to suggest that "it is only because that struggle [between capitalism and socialism] loomed for so long that we have failed to see that, in most other respects, the 'neo-American' and 'Rhenish' models are not merely different, but antagonistic." Crouch & Marquand, *Introduction to Ethics and Markets: Co-operation and Competition within Capitalist Economies* 1 (Colin Crouch & David Marquand eds. 1993). And these theorists attribute this difference to the length and strength of the "parliamentary parenthesis" in various societies and nations, suggesting that:

> the longer the interval, or the sharper the breach, between the destruction of ancient guild and *Stãndestaat* institutions and the construction of typically 'modern' interest organizations, the more committed did the state become to liberal modes of interest representation, and the less likely to tolerate sharing political space; the less likely were modern organizations to target their ambitions on participation of that kind; and the less likely were neo-corporatist institutions to become established.

Crouch, "Sharing Public Space: States and Organized Interest in Western Europe," in *States in History* 177 (John A. Hall ed. 1986). For an application of this theory to certain phases of the "thrift crisis" of the 1980s, a precursor to our contemporary "financial crisis," see Langbein, "The Thrift Crisis and the Constitution," 53 *Wash. & Lee L. Rev.* 159, 167–170 (1996). For one of many instances in which the clash continues to inform a broad array of public policy choices that involve international cooperation (namely, the role of "leverage" capital requirements in relation to "risk-weighted" capital requirements, a subject that warrants extended treatment in itself), see Braithwaite, "U.S. Prepares to Push for Global Capital Rules," *Financial Times* (4/26/10), available at *http://www.ft.com/cms/s/0/28959166-5082-11df-bc86-00144feab49a.html* (last visited Apr. 26, 2010):

> The most important fault line runs between a bloc of countries that includes the US, the UK and Switzerland and one that includes Germany, France and Japan.
>
> The first group is enthusiastically behind a substantial increase in capital ratios coupled with a more conservative assessment of what counts as capital, tough liquidity rules and a new simple leverage ratio.
>
> The second group is more attached to the pre-eminence of the current risk-based approach and wants the leverage ratio to have a much less important role in governing banks' balance sheets.

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called with some unease ''rhenish capitalism,'' was based on principles, more than rules; functioned with greater coordination between business and government, and some obscurity as to the distinction between the two; was much more tolerant of nonpublic arrangements between business and governments; and functioned through highly integrated, large, centralized national institutions.

Most particularly, the former form of capitalism entailed a broader area of ''public space,'' in which ''the range of issues over which general, universal decisions are made within a given political unit, particularly decisions which are seen by political actors to affect overall social order,'' is ''monopolized by specialized political institutions: legislature, executive, and judiciary,'' rather than dominated by organized private interest groups.[111]

In a real sense, arm's-length, despite the universal obeisance paid it by all free market governments, is a product of the ''rhenish'' way of doing business. It was made even more so in 1991 by the institution of ''Advance Pricing Agreements,'' which, in violation of existing law, were held confidential, and as to which the law was amended to assure their confidentiality once a major publisher brought a lawsuit challenging the Service's earlier position on confidentiality.[112] The proposal of the critics of arm's-length for ''modified fractional apportionment,'' by contrast, was an effort to introduce a more rule-formal, open and consistent set of rules, consistent with a determination to impose tax on transnational corporate income — if you will, a more ''American'' way of doing business.

4. Clinton Policy and the Retreat from Anglo-American Capitalism

Moreover, the distinction between these two antinomies in some sense defines the larger path the Clinton Administration took toward the international economy. The theory of free trade, it must be remembered, was developed at a time when the sovereigns in question were not democratic republics, but mercantilist monarchies, when sovereignty had a highly personal character. The theory, and practical demands for trade, helped undermine and ultimately destroy the monarchical form of government. The theory of free trade still holds when evaluating government measures explicitly motivated by a policy of giving advantage to particular economic actors subject to a sovereign's jurisdiction. But the efficiency properties of free trade are always less clear when aimed at dismantling internal policies devised not for purposes of revenue grabbing or protecting favored constituencies, but to promote the general welfare, such as ''entitlement'' programs, or the taxation of capital or corporate income.

In an acid coda played after the regulations and Guidelines were in final form, the Treasury held a ''conference'' on formula apportionment in December 1996, slightly more than a month after President Clinton's re-election. Then–Deputy Secretary Larry Summers played host to the hearings. The hearings were held at the insistence of Senator Byron Dorgan of North Dakota, a former Chair of the Multistate Tax Commission, who long was the only member of Congress who took a serious interest in the allocation question, and was a strong advocate of an international move to formula apportionment. Indeed, it was widely rumored that holding the conference was a price the Administration had to pay in order to avoid Senator Dorgan's placing a hold on Summers's nomination as Deputy Secretary.

In his opening remarks, however, Summers went a distance well beyond any that was justified in singing the praises of arm's-length and denigrating the subject of the conference. He began (with perhaps uncharacteristic sarcasm) by ''thank[ing] Senator Dorgan for his leadership on this subject.'' But he then immediately ''stress[ed] at the outset, the full, unqualified, support of the United States government for the international consensus that has developed on how to tax the cross-border transactions of multinational corporations,'' and assured his audience that ''[t]he fact that the Treasury Department is holding this conference does not indicate in any way that our support for the arm's-length method is wavering.'' He averred that ''[t]he Clinton administration has made tremendous progress in improving the efficiency and application of the arm's length standard,'' celebrating that ''[t]he U.S. joined with tax administrators of the OECD member countries in issuing a report that provided a ringing endorsement of the arm's length principle.'' As for fractional apportionment, the Deputy Secretary allowed that ''it may be time to examine whether more radical changes to our tax system are in order,'' but said that ''major new cooperative steps to tax multinational corporations'' had ''already occurred, as shown by our trading partners' unanimous endorsement of our new transfer pricing methodologies.'' He compared formula apportionment to ''other radical reforms proposed to our tax system,'' but concluded for-

[111] Crouch, ''Sharing Public Space: States and Organized Interest in Western Europe,'' in *States in History* 177, 179–81 (1986).

[112] *See BNA v. IRS*, D.D.C., No. 96-CV376, 2/27/96. For an account of the confidentiality dispute, see Ring, ''On the Frontiers of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income from Cross-Border Transactions,'' 21 *Mich. J. Int'l L.* 143, 186, 204–07 (2000). The Service's initial position is described in Turro, ''United States: IRS Official Says No APA Disclosure, But Generic Information to Be Provided,'' 4 *Tax Notes Int'l* 709 (4/6/92) (quoting then IRS Associate Chief Counsel International, Robert E. Culbertson); Stratton, ''Competing Interests Snag APA Program Guidance,'' 70 *Tax Notes* 138, 139 (1996). The position was criticized (to the point of ridicule) by Mogle, ''Advance Pricing Agreements Under Revenue Procedure 91-22,'' 45 *Bull. for Int'l Fiscal Documentation* 356, 359–60 (July/Aug. 1991); McIntyre, ''The Case of Public Disclosure of Advance Rulings on Transfer Pricing Methodologies,'' 91 *Tax Notes Int'l* 2–27 (1/9/91). During the course of the lawsuit, the Service changed its position and announced an intention to disclose the APAs. Moses, ''Judge Allows BNA to Propose Schedule for IRS to Make APAs Publicly Available,'' 28 *BNA Daily Tax Rpt.* G-7 (2/11/99); ''IRS-Treasury Letter Announcing Intention to Settle BNA APA Lawsuit,'' 7 *Tax Mgmt. Transfer Pricing Rpt.* 88 (1/27/99) (copy of letter sent to APA participants indicating the Service's intent to disclose APAs under I.R.C. 6110). Congress responded in 1999 by amending §6103(b) to protect the APAs from disclosure.

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mula apportionment ''is not a realistic alternative to the arm's-length standard.'' [113]

Much of the objection and popular resistance to the kind of ''globalization'' policies sired by the Clinton Administration have been motivated by that administration's losing sight of, or abandoning, the distinction between dismantling policies expressly aimed at protection, and dismantling policies that serve the general welfare but at the expense of inconveniencing (or even penalizing, or taxing) major economic actors. Indeed, radical and aggressive ''rhenification'' of U.S. economic policy seems in the long run likely to be the hallmark and signal achievement of the Clinton Administration, effected under the able, if now somewhat discredited, tutelage of its last two Treasury Secretaries, Robert Rubin and Lawrence Summers. Quite visibly, the administration's quick abandonment of its campaign promises regarding transfer pricing were of this character. And equally visibly, a precise understanding of the distinction between the first Bush Administration's ''net income benchmarking'' approach, and the true nature of the theoretical critique of arm's-length, illumines the inner character of the more comprehensive betrayal prefigured by that abandonment.

VII. THE FATE OF THE MID-1990s REVISIONS

To sum up the situation by the mid-1990s: There was substantial academic authority and empirical evidence that the prevailing approach to taxing TNCs was incurably unworkable, although many active professionals in the field, knowing this, remained mute about it. The incumbent administration in the U.S. had come to power implicitly but publicly promising to change this system, yet had quickly (though privately and quietly) retreated from the position even before assuming power. The government itself had published studies and regulatory proposals that took account of the opposition to the status quo, yet it refused to renounce fidelity to the prevailing ideology, and had proposed alternatives that were corrupted by narrow concerns for revenue and possibly for industrial protection as well.

The results were the revisions of the regulations and the OECD Guidelines in the mid-1990s. Durst's question is how the revisions worked out in addressing the problems identified with the pre-existing regime.

A. Interpretive Differences

1. The Modified Regulations as Giving Primacy to Profit Splits

Before detailing the (relatively easy) answers to this question, it is worth noting differences concerning interpretations of the essential content of the revised regulations. Again, the differences can be defined as between my own interpretation, and interpretations described (if not necessarily accepted) by Durst and Culbertson. Although the matter requires extended discussion, which I have set forth elsewhere,[114] in my view, if the regulations are read carefully, and the requirements for comparability and other limitations set forth with respect to the various ''methods'' allowed by the regulations are taken seriously, the regulations devolve into a regime where the predominant method used will be the residual profit split method, with profits split according to a single-factor formula, the single factor being intangible development costs. Four key features of the regulations, as promulgated in 1995, accomplish this. These are certain examples of the rules governing comparability and contractual terms;[115] the rules governing locating the ''owner'' of intangible property,[116] especially as elucidated by certain examples that won fame as the ''cheese examples'';[117] and the rules governing the residual profit split method itself.[118]

Based upon this analysis, it was originally my view that the promulgation of the mid-1990s revisions represented less a triumph of the status quo, and less a defeat for the advocates of basic reform, than had usually been supposed. This is because the residual profit split method, as most commentators observed and agreed, was a quasi-fractional method, a kind of way station between conventional arm's-length and formula apportionment. It was not a very good fractional method. There was (and is) little justification, theoretical or otherwise, for using ''intangible development costs'' as a single allocation formula. Moreover, there is ambiguity aplenty, little of it resolved by the regulations or Guidelines, as to what constitute such costs. But its prominence in the regulations was more than a minor nod in the direction of a wholly different approach from that taken historically.

2. The Modified Regulations as Giving Rise to Endless Searches for Comparables

To reach these conclusions one had to read the regulations in a particular way, although I believe it was the right way to read them. But the regulations were a mass of detail, and indeed to some extent contradiction; they listed numerous methods, overlaid by an ambiguous and novel ''best method'' rule, and gilded by novel directions for constructing ''arm's-length ranges'' with an ''interquartile range.'' This led, in practice, to the widespread use of various methods, with some emphasis on the resale price and comparable profits methods, always constructing ranges from the use of numerous comparables and publicly available information. Durst and Culbertson aptly describe the process:

[113] The speech is reproduced at 96 *TNT* 242-23 (12/13/96).

[114] Langbein, ''Transfer Pricing and the Outsourcing Problem,'' 106 *Tax Notes* 1299 (3/14/05).

[115] Regs. §1.482-1(d)(3)(ii)(C) *Exs. 3–6* (as amended).

[116] Regs. §1.482-4(f)(3).

[117] Regs. §1.482-4(f)(3)(iv) *Exs. 2–4* (superseded). On the ''fame'' (or ''notoriety'') of the ''cheese examples,'' see Durst & Culbertson, at 117–18 & n.283.

[118] Regs. §1.482-6(c)(2)(ii)(B) (as amended).

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The interquartile range quickly became a fixture of U.S. transfer pricing practice. For many companies, contemporaneous documentation for U.S. purposes has become a matter of determining a 'tested party' — that is, the entity within the group that conforms most closely to the routine, limited-risk paradigm underlying CPM — and then performing a search for comparables from compilations of data reported to the SEC by publicly traded companies. Typically, the search begins by identifying several hundred companies in a relatively broad Standard Industrial Classification category into which the tested party appears to fit. Then, typically following a predetermined pattern, the person performing the search applies various 'screens' — that is, eliminating companies with specifically identified R&D expenditures above a certain level, companies with repeated losses, and companies differing greatly in size from the tested party — in order to narrow the list of potential comparables.

The person performing the search then reads the detailed descriptions of the companies on the narrowed list that are contained in SEC disclosure statements, and on the basis of this reading applies subjective judgment to select a final list of comparables. The Service and private practitioners apply this method in a large number of cases on an everyday basis; the IRS APA Program has published detailed training materials describing this approach, and IRS personnel outside the APA Program also apply it routinely.

In broad outline the approach used conforms to that envisioned by the authors of the White Paper, but in practice the situation is quite different. . . . [G]iven the small sample sizes that could arise in the context of a comparability-driven CPM, the regulations identified the interquartile range as a method that can apply to small samples.

. . . [W]e are not convinced that the statistical approach makes sense when sample sizes are very small. It is our experience that when a handful of comparables is involved in the analysis, meaningful distinctions can be drawn that permit the taxpayer to be more closely identified with some subset of the comparables, and that resorting to the purely mechanical computation of an interquartile range in such circumstances is relatively likely to produce implausible results. This follows from the fact that there is no theoretical reason to view the range identified under this method as conferring any degree of confidence that data within the range is or is not normal.

Indeed, in our experience application of the interquartile range to small samples often results in the creation of a range that is too wide to be of practical use in resolving cases. Sample sizes in fact tend to be small; while relatively few studies in our experience narrow the comparables to a sample as small as four, sample sizes of less than ten are common. As would be expected given the wide ranges of results that even very similar businesses experience in practice, the resulting ranges tend to be extremely wide, often ranging from low negative numbers (for example, a net operating margin of –2%) to relatively high positive numbers (for example, a net operating margin of 8.5%).

* * * *

A less technical but nevertheless serious concern is that current practices relating to a comparables search and the construction of an interquartile range have affected the dynamics of dispute resolution by giving an appearance of scientific method to what is in fact a subjective analysis. This appearance of scientific method can make it much harder to resolve cases: As a psychological matter it is far easier to compromise over differences of acknowledgedly subjective viewpoints than to admit shortcomings in analyses that one is compelled to present as objective.[119]

This passage does describe actual practice under the revised regulations. A careful evaluation of comparables, and careful use of the string of comparability considerations/embedded intangibles/intangible ownership/residual profit split is thrown overboard, at the siren song of the pseudoscientific ''interquartile range'' and the ''arm's-length range.'' Methods such as the CPM and resale price are revivified in the process. But the end result is entirely reminiscent of results described early and late under the 1968 regulations: a broad spread between the position of the taxpayer and that of the government; and disputes that are resolved on what in the final analysis are openly subjective bases. Durst and Culbertson add some additional problems under the revised regulations: that supposed objectivity only makes disputes more difficult to resolve; that the detour through the apparently scientific rules devours resources and limits the government's capacity to audit substantial numbers of

[119] Durst & Culbertson at 110–112 (footnotes omitted).

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taxpayers; that the entire exercise demoralizes the government staff, and sometimes even the professionals who represent the taxpayers.[120]

I do concede that practice under the regulations (during their first decade) conformed much more to the picture Durst and Culbertson paint than to the one I sketch of the true content of the regulations. Notwithstanding this, I think there is one powerful bit of evidence that my reading is the correct one. This evidence is the regulatory changes the second Bush Administration proposed in 2003,[121] promulgated as temporary regulations in 2006,[122] and made final in 2009.[123] The proposals accompanied other changes the Bush Administration made in the regulations, a broad proposal for new rules governing allocations with respect to ''intercompany services'';[124] and a revision of the cost sharing rules.[125] But the proposals that revised the main body of the transfer pricing regulations were aimed precisely at those features of the regulations that I argued made those regulations, read properly, a quasi-fractional regime: the comparability rules; the intangibles ownership rules (with the cheese examples, which the Bush amendments removed); and the substantive rules governing the residual profit split. The effect of the changes was to eliminate the formerly pre-eminent role played by ''intangible development costs.'' And their effect was to weaken, if not destroy, the manner in which those rules functioned to push the residual profit split to the foreground as the ultimate method to be used in making allocations. At the same time, by rendering indefinite how the residual profit split should be accomplished when the method was used, the changes emulsified whatever clarity the presence of that method had lent to the overall regulatory scheme. Thus, the conservative administration ''de-fractionalized'' the system adopted in the mid-1990s, and retreated further toward the ''ante bellum'' arm's-length system.

However the regulations are read or administered, there remains the question of evaluating what they have accomplished. By 2003, when Durst and Culberson wrote, there was already trouble. I have quoted above where much of the trouble lay — in the acceptance of the invitation by the regulations to construct ''interquartile ranges,'' large amounts of compliance cost was incurred without discernibly reducing, and sometimes enhancing, the apparent subjectivity of the results reached. But the theme of Durst and Culbertson's article points to a more fundamental problem with the regulations, when applied in the context of legislative changes adopted in 1990.

B. Ex Ante Documentation and Ex Post Standards as Described by Durst-Culbertson

It should be noted that, after amending §936 in 1982, and adopting the §367 superroyalty in 1984 and the §482 superroyalty in 1986, Congress never again, during these ''wars,'' addressed the *substantive* issues raised by transfer pricing. It did, however, enact in 1990 a severe transfer pricing penalty under §6662. This gave rise to the need for companies to produce ''contemporaneous documentation'' supporting their transfer prices. This led to what Durst and Culbertson, in the most trenchant phrases of their piece, identify as the ''root of the dilemma'' of an ''incomplete paradigm shift'': the ''conflict between ex ante procedural rules and ex post substantive rules.'' By this they referred to the requirement that taxpayers defend in advance their position, while the regulations continued, as they had in 1968, to grant broad leeway to administrators to select methods to test transactions or intercorporate arrangements after the fact.

And responsibility for this conflict Durst and Culbertson assign unambiguously, if inexplicitly, not to Congress, but to the foreign defenders of arm's-length. They quote extensively from the OECD Guidelines, in parts that have little or no parallel in the U.S. regulations, showing those Guidelines ''adopting with relish the approach of the 1968 U.S. regulations,'' which:

> consist to an almost astonishing extent of (1) lengthy enumerations of factors that must be taken into account in performing a proper functional analysis of the circumstances surrounding each set of controlled transactions, and (2) stern warnings against any attempt to infer generally applicable rules that might reduce the need for detailed factual inquiry in each specific case. The overall image created is that the notion that transfer pricing analysis could be simplified in a manner that would permit its large scale application is *a demon that must be warded off* with repeated verbal incantations.
>
> [L]ists, or language requiring reference to large volumes of facts, appear throughout the Guidelines. Also, and in a variety of contexts,

[120] This plaint about the condition of professionals working on transfer pricing matters appears to have a dual aspect, suggesting at once that the condition is a reason to seek improvement in the rules, and also that the professional community can play a significant role in effecting such an improvement. I tend to doubt both propositions.

[121] *Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles*, 68 Fed. Reg. 53447 (9/10/03).

[122] T.D. 9278, 71 Fed. Reg. 44466 (8/4/06).

[123] T.D. 9476, 74 Fed. Reg. 38830 (8/4/09).

[124] These were finalized by T.D. 9476 in 2009 as Regs. §1.482-9.

[125] The Treasury promulgated a notice of proposed rulemaking to amend the cost-sharing rules on Aug. 29, 2005. 70 Fed. Reg. 51116. These rules, substantially amended, were promulgated as temporary regulations on Jan. 5, 2009, as T.D. 9441, 74 Fed. Reg. 340. The temporary regulations are set forth at Regs. §1.482-7T, and expire on Dec. 31, 2011. Regs. §1.482-7T(n). They are effective after Jan. 4, 2009. The prior regulations, effective until Jan. 4, 2009, appear at Regs. §1.482-7A.

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> the Guidelines stress repeatedly that *in no instance can generally applicable principles be distilled and applied*, but that transfer pricing analysis *is legitimate only if* it is based in each instance on exhaustive analysis of the facts and circumstances.
>
> * * * *
>
> [T]he Guidelines do not seem to entertain any real illusion that in practice, either taxpayers or revenue authorities can take into account the enormous volume of factual items that reasonably might be expected to affect market prices even in relatively simple business situations. Instead, what the Guidelines seem to envision — indeed, to advocate — is *a return to historical patterns in which transfer pricing examinations were relatively low-key affairs, and resolutions were negotiated effectively on a gestalt basis*.[126]

As I have noted throughout, the regulations and Guidelines were developed in tandem and appear to track each other. But in this respect there is clear deviation between the two, as Durst and Culbertson ably detail. This harkens back to a conflict I described in my criticism of the political stance of the Clinton Administration toward transfer pricing and toward globalization generally. Here the difference between the U.S. and OECD approaches reflects the difference in types of capitalism described in the sociological literature of the early 1990s: between a ''rhenish'' species (''examinations were relatively low-key affairs, and resolutions were negotiated effectively on a gestalt basis'') and a more rule-formal, predictable, determinant *public* and *publicly acceptable* basis.

VIII. EVALUATING THE REGULATIONS

A. The Avi-Yonah/Clausing/Durst Catalogue of Problems

As to how the revised regime has functioned, there is little to add to the diagnosis set forth by A-YCD. The recent A-YCD article eschews repetition of the details of the theoretical objections to arm's-length, although it relies heavily on the *fact* of those objections. The A-YCD article rather focuses upon a catalogue of the practical detriments of the use of arm's-length. I have little to add to either their list or their description of the problems:

- Most fundamentally, the SA [separate accounting] system ignores the fact that multinational groups of companies arise precisely in order to avoid the inefficiencies that arise when unrelated companies must transact with one another at arm's-length;[127]
- [T]he porosity of current transfer pricing rules creates an artificial tax incentive to locate profits in low-tax countries, both by locating real economic activities in such countries and by shifting profits toward more lightly taxed locations;[128]
- [T]he current system is absurdly complex. . . . [which] observers have described . . . as 'a cumbersome creation of stupefying complexity' with 'rules that lack coherence and often work at cross purposes';[129]
- [P]articularly given the high U.S. corporate statutory tax rates, the U.S. corporate tax system raises relatively little revenue;[130]
- [I]t is important to note that the problems with the current system derive not from rules at its periphery, but instead from a fallacy that lies at the system's central core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement.[131]

They then describe the undesirable ''results'' of this system:

- Companies and the government spend extraordinary sums each year on efforts at compliance and enforcement;[132]
- Despite the expense of compliance and enforcement, companies and the IRS typically are dramatically far apart in their determinations of arm's-length pricing;[133]
- The inability to predict whether their positions will be sustained leaves companies and their investors with large areas of uncertainty in their financial statements;[134]
- The absence of clear standards for compliance, coupled with the ability under the arm's-length standard to apportion income to low-tax countries through legal arrangements governing the siting of intangibles and (more recently) the bearing of

[126] Durst & Culbertson at 106–108 (emphasis added).

[127] A-YCD at 501.

[128] *Id.*

[129] *Id.* at 502.

[130] *Id.*

[131] *Id.* at 503.

[132] *Id.* at 504.

[133] *Id.* at 505.

[134] *Id.*

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- risk, make it impossible for Congress to predict with reasonable accuracy the actual amount of federal revenue that will be raised as a result of any particular corporate tax rate that Congress believes it has enacted;[135]
- [T]he resolution of issues involving such large amounts of money, without the benefit of clearly discernable decision-making standards and public scrutiny, is not healthy for the tax system;[136]
- A related problem is that the uncertain results under current transfer pricing law degrade the quality of tax practice on the parts of both taxpayer and government representatives;[137]
- The resulting atmosphere contributes to a lessening of the publicly perceived credibility of both corporations and the government — a development that is seriously damaging to . . . a largely mixed economic system;[138]
- The vulnerability of the current transfer pricing system to the shifting of income based on intangibles ownership and risk-bearing makes necessary numerous additional complexities in the international tax system;[139]
- The current transfer pricing system . . . can be seen as the tail that wags the dog of much unnecessary tax complexity.[140]

B. Observations on the Problems

1. Continuum Price Problems: Resurrection of Problems of the Old Regime

Four points are in order.

First, this account suggests the revisions of the mid-1990s accomplished virtually nothing and indeed were counterproductive. The situation is what I described in 1986 as ‘‘continuum price derangement’’: There is a long continuum of prices, encompassing often a substantial or majority percentage of gross revenue, along which *any* price is one that would bring the two hypothetically ‘‘unrelated’’ parties to the table.[141] This generates the large area of controversy, the commitment of undue amounts of resources to the problem, the uncertainties for both business and government. I do not think it was foreordained, by the revised regulations as written. As I note above, those regulations could have been read to move the system toward a quasi-fractional one that was at least more orderly and predictable than the system under the 1968 regulations. But this is not the course the governments and taxpayers took, egged on, no doubt, by the stance of the OECD Guidelines against the use of any a priori criteria, and by taxpayer representatives, principally the large accounting firms, anxious to employ their large databases in connection with the spuriously objective notions that riddle the regulations and Guidelines. That having been accomplished, there is little reason to question the conclusions of A-YCD that the current system is at least as ‘‘schizoid’’ — the word I used in 1986 — and unworkable as that under the 1968 regulations, quite possibly more so.

2. New Difficulties Under Revised Regulations

Second, however, there are sounds of new complaints that were not there, or at least not so pronounced, in the early and mid-1980s. These have a triple aspect: the ‘‘degrad[ation of] the quality of tax practice on the parts of both taxpayer and government representative,’’ the ‘‘health’’ of the overall tax system; and the ‘‘credibility of *both* government and corporations’’ (not the tax system). One might add a fourth point, although this was I think always implicit in the whole debate about transfer pricing — that it renders all other international tax discussion, whether about specific issues (allocation of deductions to deferred income, for example) or overall policy (capital export neutrality, ‘‘national’’ neutrality, national welfare versus worldwide welfare, ‘‘ownership’’ neutrality, ‘‘territoriality,’’ for that matter) either secondary or unimportant, or outright evasive.

There is yet something more to be said about this set of considerations. Not only did we not articulate them in the late 1980s and early 1990s, but even as late as 2007 — in the Hamilton Project paper by Professors Avi-Yonah and Clausing — there is little if any mention of them.[142] They seem either to be the exclusive contribution of Michael Durst (which I believe unlikely) or mattered more to Professors Avi-Yonah and Clausing (and other authors) in 2009 than in 2007; I exclude the possibility that these concerns arose, as an objective matter, in the two-year interval.

I believe it is fair to say that the presence of these concerns — and they are present — is not purely attributable to arm's-length itself as such, but draws a lot from the history of the last 25 years. That is to say, while the system may be deranged, and may have been so all along, the fact that it was retained and furthered, and continues to be, in the face of widespread recognition of its derangement, is an independent and perhaps greater concern than the immediate consequences of the system itself.

3. The Difficulties and the Distinction Between ‘‘Anglo-American’’ and ‘‘Rhenish’’ Free Enterprise

Third, much of the complaint registered sounds in values of the old ‘‘American’’ system of capitalism, in

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[135] *Id.*
[136] *Id.* at 506.
[137] *Id.*
[138] *Id.*
[139] *Id.*
[140] *Id.* at 507.
[141] Langbein, *Unitary Method*, at 654–66. See also Notice 88-123, 1988-2 C.B. 458 (White Paper).

[142] Clausing & Avi-Yonah, ‘‘Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment’’ (Brookings Institution 2007). The document is available at 2007 *TNT* 114-38.

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its differentiation from the more "rhenish" variety. Much emphasis is placed on predictability if not certainty — for businesses planning strategy, Congress implementing fiscal policy, the public formulating its views and its evaluation of Congress. Emphasis is placed, too, on the integrity and the publicity of the process, values not so much stressed on the continent.

4. The Avi-Yonah/Clausing/Durst Catalogue and the Financial Crisis

Fourth, and possibly most serious, the A-YCD article was written — in contrast to the original Hamilton Project piece by Professors Avi-Yonah and Clausing — *after* the full onslaught of the 2007–08 financial crisis, and I think some of the concerns, which I suggested above were much more clearly stated in 2009 than in 1986 or 1994, and even 2007, reflect the public reaction to the crisis. This seems clearly true of the concern for the credibility of both government and corporations, a concern that presents itself in rather novel form in the current environment. In the past, politics has lined up with questions about the credibility of one or the other, with the "left" mistrusting business, and the "right" mistrusting government; but now there is widespread mistrust of both, and it tends to be concentrated in what we generally think of as the political "center."

It is true, too, of the concern for the "degradation" of practitioners. However it may be that, "[i]n the authors' experience, those involved in this process have served their roles with both integrity and skill," [143] it is nevertheless true, as I have suggested throughout, that many of "those involved," including one of the authors, have kept their peace during the debates over this process apparently much beyond the point at which they reached conclusions at variance with the views of the powerful interests in whose service they were employed.

This final point suggests that lessons may be learned from the transfer pricing episodes of the past quarter century about larger, indeed general, questions of the future of the currently unsettled international economy.

IX. THE WORK OF THE EUROPEAN COMMISSION TASK FORCE

This recognition of the continuing difficulties of the arm's-length system has been accompanied by a decided softening of views, mostly in Europe, of the viability of formula methods, as will be discussed. The result has been two initiatives advocating adoption of formula apportionment, one by the European Community, the other by the Brookings Institution's Hamilton Project in the United States.

A. Establishment of Task Force

In 2001, the European Commission ("the Commission") broke with the idea of treating TNCs as a collection of independent entities operating at arm's-length, and informed the European Council of its intention to introduce a Common Consolidated Corporate Tax Base (CCCTB), with formula apportionment, as a new way of taxing TNCs based in the European Union (EU).[144]

In 2004, the Commission, with the approval of the economics and finance ministers of the Member States of the European Union, established a CCCTB Working Group to evaluate the possibility of establishing a common European tax base.[145] The European Commission is the body within the EU with authority to propose legislation and implement EU policy, but it has no authority to enact tax legislation. That power is exercised by the European Council of Members (the "Council"). The Council is composed of sitting ministers of the Member States, but its actions require unanimity. Any Member State may exercise veto power over the action of the Council.[146]

The Commission has authority, however, to bring litigation against Member States before the European Court of Justice (ECJ), to enforce the "four freedoms" established under the EU treaty — the freedom of movement of capital, the freedom of movement of labor, the freedom to provide services, and the freedom of establishment. This litigation has resulted in a long line of decisions, rendered principally with respect to the freedom of establishment, which have restricted the power of states to enforce such matters as controlled foreign corporation provisions or thin capitalization rules.[147] These decisions have generated considerable controversy, and were part of the motivation to establish a CCCTB.

B. The European Commission and Tax Harmonization

The Commission has a long and substantial history of advocating tax harmonization, of rates and base,

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[143] A-YCD at 506.

[144] Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, "Towards an Internal Market Without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities," *COM* (2001) 582 final, available at http://eur-lex.europa.eu/LexUri Serv/LexUriServ.do?uri=COM:2001:0582:FIN:EN:PDF.

[145] *See* Weiner, "Practical Aspects of Implementing Formulary Apportionment in the European Union," 8 *Fla. Tax Rev.* 629, 643 (2007).

[146] For a description of the structure of the relevant European Union institutions, see Warren & Graetz, "Income Tax Discrimination in the European Union," 115 *Yale L. J.* 1186, 1188–89 (2007).

[147] *See, e.g., Cadbury Schweppes plc v. Commissioners of Inland Revenue*, C-196/04, 2006 E.C.R. I-7995; *Marks & Spencer plc v. Halsey*, C-446/03, 2005 E.C.R. I-10837; *Manninen*, C-319/02, 2004 E.C.R. I-7477; *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*, C-324/00, 2002 E.C.R. I-11779. For a discussion of these cases, see Warren & Graetz, "Income Tax Discrimination in the European Union," 115 *Yale L. J.* 1186, 1188–89 (2007); Dahlberg, *Direct Taxation in Relation to the Freedom of Establishment and the Free Movement of Capital* (2005).

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within the European Community (EC), which was replaced by the EU under the 1992 Treaty of Maastricht. In 1961, the predecessor Commission established working groups to study harmonization, and established a Program for the Harmonization of Direct Taxes. It continued to advocate harmonization for 30 years, until it became clear that harmonization was not acceptable to all states, and thus not acceptable to the Council.[148]

In 2004, the Commission expressed an intention that the newly formed Working Group would unveil a CCCTB proposal by the end of 2008. But by August 2008, Lazlo Kovacs, EU Tax Commissioner, announced a delay, declaring that he would rather present ''a perfectly elaborated and well justified product at the appropriate time'' than ''an incomplete one just to meet an artificial deadline,'' although he remained ''fully committed to this project.'' [149]

Certain parameters of the CCCTB were established in advance by the Commission. First, it was understood throughout that the CCCTB would be voluntary; companies would be permitted to continue using their national tax systems. This condition was essential to securing business community support for and participation in the project. Second, it was understood that the formula apportionment system to be adopted would stop at the EU's ''water's edge,'' that is, it would allocate tax base among EU members, but would not attempt to apportion the worldwide income of EU entities between the EU and the rest of the world.

The four years of study by the CCCTB Working Group have been documented in public release of the results of its meetings.[150] The Working Group paid careful attention to the U.S. states' experience with fractional apportionment. The lessons of the interstate experience for the EU have generated a substantial body of literature in the United States and Europe.[151]

C. Delay of Final Recommendations of the Task Force

However, as the project deadline approached, completion proved impossible, largely for the main reason the OECD Guidelines and OECD spokespersons had advanced for rejecting formula apportionment in the mid-1990s: the impossibility of securing international agreement, first on the use of formulary methods, and second on identifying the appropriate allocation criteria.[152] As to the first, the project appears to have encountered resistance mainly from countries with lower taxes and tax incentive programs designed to attract capital investment by multinationals. As to the second, in its most recent deliberations, the Working Group contemplates a cumbersome six-factor formula, based on employees, payroll, tangible assets, intangible assets, destination-based sales, and origin-based sales.[153]

Nonetheless, the CCCTB project is a measure of a goodly distance traveled since the inception of the attack by foreign governments and multinationals on the state systems in the mid-1970s, and the ''transfer pricing wars'' of the 1985–95 period. No other issue, as Richard Vann once observed in the early 1990s, generated the ''heat'' that transfer pricing did — but by the time of the CCCTB project inception, John Neighbour, an OECD official, reportedly observed that some of the ''political heat has gone out'' and the passage of seven years should enable parties to ''look a little more coldly'' at pricing controversies.[154] Professors Avi-Yonah and Clausing note, entirely accurately:

[148] *See generally* Warren & Graetz, ''Income Tax Discrimination in the European Union,'' 115 *Yale L. J. 1186*, 1227–29 & n. 143 (2007); Jimenez, *Towards Corporate Tax Harmonization in the European Community: An Institutional and Procedural Analysis* (1999).

[149] Kovacs, Eur. Comr. for Taxation & Customs Union, Keynote Speech at the Congress of the International Fiscal Association (8/31/08), available at http://ec. europa.eu/commission barroso/kovacs/speeches/2008/0831IFA.pdf.

[150] *See, e.g.,* European Commission, Directorate-Gen. Taxation & Customs Union, ''Summary Record of the Meeting of the Common Consolidated Corporate Tax Base Working Group,'' CCCTB/WP/055 (June 28, 2007), at 1, available at http://ec.europa.eu/taxation customs/resources/ documents/taxation/company tax/common tax base/CCCTBWP055 summary en.pdf (March 2007 meeting).

[151] *See, e.g.*, Hellerstein & McLure, Jr., ''The European Commission's Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States,'' 11 *Int'l Tax & Pub. Fin.* 199, 201 (2004); Hellerstein & McLure, Jr., ''Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experience for the European Commission's Company Taxation Proposals,'' 58 *Bull. Int'l Fisc. Doc.* 86 (2004); McLure, Jr. & Weiner, ''Deciding Whether the European Union Should Adopt Formula Apportionment of Company Income,'' in *Taxing Capital Income in the European Union: Issues and Options for Reform* 243 (Sijbren Cnossen ed., 2000); Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (2006).

[152] *See* O'Shea, ''Tax Harmonization vs. Tax Coordination in Europe: Different Views,'' 46 *Tax Notes Int'l* 811, 813 (5/21/07) (''[There is] no presumption that coordination will lead to Europe-wide action,'' quoting Dawn Primarolo, U.K. Paymaster Gen., Statement Before the U.K. House of Commons European Standing Committee (3/6/07), available at http://www.publications.parliament.uk/pa/cm200607/cmgeneral/euro/070306/70306s01.htm); Hey, ''EU Common Consolidated Corporate Tax Base: Guided Variety Versus Strict Uniformity — Lessons from the U.S. States' Tax Chaos'' 2 (Jean Monnet Working Paper No. 02/08, 2008), available at http://www.jeanmonnetprogram.org/papers/08/080201.pdf; Kofler & Mason, ''Double Taxation: A European 'Switch in Time'?'' 14 *Colum. J. Eur. L.* 63 (2007); Weiner, ''Cooperation in European Tax Reform: Why Can't We Be Friends?'' 45 *Tax Notes Int'l* 939 (3/12/07).

[153] Mintz & Weiner, ''Some Open Negotiation Issues Involving a Common Consolidated Tax Base in the European Union,'' 62 *Tax L. Rev.* 81, 106–07 (2008).

[154] Durst & Culbertson at 129 n.316, quoting ''OECD to Conduct Peer Review of Mexico's Transfer Pricing Policies, Rules,'' 10 *Tax Mgmt. Transfer Pricing Rpt.* 993 (4/17/02).

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> For anyone who has followed the formulary debate for some time, the EU move toward CCCTB is amazing. CCCTB could not move forward without support from Germany, which traditionally has been at the forefront of opposition to any departure from the classic arm's length standard and the traditional transfer pricing methods. CCCTB also could fail if the United Kingdom were opposed, and the United Kingdom spearheaded the opposition to California's use of world-wide formulary apportionment in the 1980's and early 1990's.[155]

Indeed, in a symposium apparently timed to coincide with the announcement of final action on the CCCTB, the *Tax Law Review* featured an article, together with a number of comments, not on the merits of arm's-length versus fractional apportionment, but rather on the application of game-theoretic approaches to the question of how to procure agreement within the EU on the adoption of the CCCTB, with fractional apportionment.[156] Contemporaneous scholarship addressed what we might call ''sub-legal'' means of achieving coordination (''soft law'' and ''co-operative'' approaches) by a premier student of state fractional methods.[157]

It is fine for nations to argue for their own fiscal interests, on their own terms, just as it is fine for taxpayers to minimize their taxes legally and to advance public policy positions that favor mitigation of corporate taxation. And it is fine for academics and public officials to invoke economic and legal theories of process in consideration of means of overcoming the tensions between principles of national sovereignty and principles of sound fiscal and economic policy.

What is not fine is what happened during the 1980s and 1990s in discussions over transfer pricing: government and business cooperatively sloganeering and perpetuating falsehood, and silencing arguments they were unable to refute, and obfuscating if not destroying meaningful public debate. Today, the debate over the viability of arm's-length is over, for all intents and purposes, as Professors Avi-Yonah and Clausing (among others) insist. Staunchly conservative commentators in defense of arm's-length make occasional, vestigial arguments that retain some force: defending cost sharing as implementing a ''comparable arrangements'' interpretation of arm's-length;[158] questioning the viability of a sales factor under formula apportionment;[159] or understanding that formula apportionment has links to the policy tradition of ''tax harmonization'' that may be hard to break.[160] But there is general agreement that arm's-length is an anachronism, either because of a change in the nature of international business, or because it served political purposes and guarded against political dangers that are no longer potent forces in the world economy.

Nevertheless, we face a wide array of challenges in international tax specifically and international economic policy generally at the present time and for the foreseeable future. These include development of an international framework for regulating financial institutions; means for ensuring the stability of such institutions without conferring privileges that immunize them from competition or legal sanction; means for extricating central banks from fiscal decisionmaking into which they have, sometimes on constitutionally questionable grounds, inserted themselves; arguments over government welfare and labor support programs; and, perhaps above all, means to combat tax evasion and to devise fiscal solutions to worldwide, deepening difficulties of government indebtedness. These will not be easy to solve, and they will entail concessions by, even setbacks for, many parties, including many powerful, private parties. The progress of theory and policy in transfer pricing teaches us lessons that will be valuable in these coming tasks, if they are properly learned. One lesson is that powerful parties will often resort to shouting down or silencing policy discussion that threatens their interests, when such discussion first emerges. Another is that the silence, equivocation, or outright dissembling of knowing professionals, often in the hire of the powerful, disserves the public interest in serious, destructive ways.

X. PROPOSALS FOR UNILATERAL ADOPTION OF FORMULA APPORTIONMENT BY THE UNITED STATES

A. Hamilton Project Paper

In June 2007, the Brookings Institution's Hamilton Project released a report — authored by Professors Avi-Yonah and Clausing — recommending that the

[155] Avi-Yonah & Clausing, ''Commentary,'' 62 *Tax L. Rev.* 119, 123–24 (2008).

[156] *See* Mintz & Weiner, ''Some Open Negotiation Issues Involving a Common Consolidated Tax Base in the European Union,'' 62 *Tax L. Rev.* 81 (2008). The comments included Avi-Yonah & Clausing, ''More Open Issues Regarding the Consolidated Corporate Tax Base in the European Union,'' 62 *Tax L. Rev.* 119 (2008); More, ''What Does 'Game Theory' Tell Finance Ministers about Whether They Should Support a Common Consolidated Corporate Tax Base in the EU?'' 62 *Tax L. Rev.* 125 (2008); Utz, ''The European CCCTB as the Outcome of a Virtual Game,'' 62 *Tax L. Rev.* 135 (2008).

[157] McLure, Jr., ''Legislative, Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income,'' 14 *Colum. J. Eur. L.* 377 (2008).

[158] E.g., Ackerman and Chorvat, ''Modern Financial Theory and Transfer Pricing,'' 10 *Geo. Mason L. Rev.* 637 (2002).

[159] Roin, ''Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment,'' 61 *Tax L. Rev.* 169 (2008).

[160] Graetz & Warren, Jr., ''Income Tax Discrimination and the Political and Economic Integration of Europe,'' 115 *Yale L. J.* 1186 (2006).

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U.S. unilaterally adopt formula apportionment based on sales as a single factor.[161] The Project involved, in its own words, an effort ''to advance America's promise of opportunity, prosperity, and growth,'' although the reports it sponsored expressed the views of their various authors, not of the Project or the Brookings Institution itself. The Project expressed a willingness ''to introduce new, sometimes controversial, policy options into the national debate with the goal of improving our country's economic policy.''

B. Obama Budget Proposals

In February 2009, President Obama's first budget earmarked $210 billion to be derived from efforts to ''implement international tax enforcement, reform deferral and other tax reform policies.'' [162] On May 4, 2009, President Obama issued a White House fact sheet detailing specifics of proposed international tax reform.[163] These included limitations on deductions allocable to income earned through foreign subsidiaries, and thus qualifying for ''deferral'' from current taxation; a proposal to require U.S. companies to determine their deemed paid foreign tax credits according to the average rate of total foreign tax actually paid on total foreign earnings, eliminating the cross-crediting of high- and low-tax foreign income; certain reforms of the ''check-the-box'' rules to prevent shifting of income to ''tax haven'' subsidiaries; a variety of rules for ''cracking down'' on abuse of tax havens by individuals; and devoting new resources for IRS enforcement to ''help close the international tax gap.''

The Obama proposals made no mention of transfer pricing. And the Administration has been equivocal in expressing continuing support for the proposals. At one point, press reported that the Administration had assured industry leaders that the proposals had been motivated only by revenue needs, and that the Administration would not seriously pursue them [164] — but the proposals nevertheless reappeared, in modified but in certain respects expanded form, in the Administration's fiscal 2011 budget.[165]

C. Durst Presentation to May 2009 Meeting of the Canadian Branch of the International Fiscal Association

But the interest shown by the proposals in international tax avoidance and evasion stirred considerable

[161] Clausing & Avi-Yonah, ''Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment'' (Brookings Institution 2007). The document is available at 2007 *TNT* 114-38.

[162] *See* 2009 *TNT* 37-1 (2/26/09).

[163] The release, ''Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas,'' appears at 2009 *TNT* 84-44 (5/4/09).

[164] King Jr. and Williamson, ''Business Fends Off Tax Hit — Obama Administration Shelves Plan to Change How U.S. Treats Overseas Profits,'' *The Wall Street Journal* (10/13/09) at p. A1:

> The story of the business community's campaign against the tax changes and the Obama administration's eventual retreat offers a window into the often uneasy relations between the White House and the corporate world. It suggests that an administration that was critical of business at the height of the financial crisis is becoming more accommodating. The White House, through a series of presidential lunches and other outreach, is trying to soothe tensions with multinational companies.
>
> Lurking behind the tax debate was the administration's need for new sources of revenue to fund its increased spending. [Lawrence Summers protégé, and former Hamilton Project Chair] Jason Furman, a White House economic adviser, made that point clear at the end of a session with a dozen or so lobbyists in March. Catherine Schultz, head of tax policy at the National Foreign Trade Council, who was at the meeting, says Mr. Furman basically told the group:
>
> ''We need the money.''
>
> * * * *
>
> When Ms. Jarrett and Mr. Summers met in mid-September with a half-dozen top executives, including Boeing Co. Chairman James McNerney Jr., deferral again dominated the conversation. But the tone was cooperative, Ms Jarrett says. ''We actually put the burden back on them — if they don't like the deferral, to think of other revenue generators,'' she says. ''We have to do something about the deficit, so I am very curious to see what response we get back.''
>
> One foe of the plan, Rep. Richard Neal, a key Democrat on the Ways and Means Committee, says, ''We've made real headway.'' He says he urged Mr. Obama personally at a White House meeting to shelve the idea until a larger tax-overhaul discussion next year. ''I don't think this will haunt the rest of the fall,'' he says.
>
> Businesses haven't dropped their guard, however.

The full story in the *Journal* is in fact less convincing about any real ''assurances'' given by the Administration than the headline suggests; the whole story exhibits some tenacity and commitment on the part of the Administration. Also, Rep. Neal's opposition to the plan has to be understood in the context of his announced intention to study transfer pricing generally in the Ways and Means Subcomittee that he chairs.

[165] The 2011 proposals limited the deduction disallowances to interest expense, and would not apply the disallowance to sales and general and administrative expenses. The fiscal 2011 budget included a new proposal to tax excess returns (30% or greater) from offshore transfers of intangibles to related controlled foreign corporations that are subject to a low tax rate (10%) by treating the amount of the excess return as subpart F income. This is a transfer pricing–type concept, and some have criticized it as a ''shocking'' entry into a ''formula-type approach,'' but the Administration has said it would be confined to situations of ''excess'' profit shifts and would not affect transfer price determinations. See 2010 *TNT* 37-3 (remarks of Barbara Angus, partner, international tax services, Ernst & Young, response of Manal Corwin, international tax counsel).

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interest among advocates of reform. There was considerable discussion of the proposals, with expressions of support from tax reform advocates,[166] and opposition from business and other conservative circles.[167] Of special note was the speech delivered to a meeting of the Canadian Branch of the International Fiscal Association (IFA) May 21, 2009, by Michael Durst, titled, ''The President's International Reform Proposals in Historical and Economic Perspective.'' Notwithstanding the absence of any direct reference in the President's proposals to transfer pricing, Durst began by relating an abbreviated statement of his version of the history of the present rules. This embodied, in hardened form, some of the matters with which I have taken issue above — notably the claim that in the early days of multinational form, the corporations ''could not function as true multinationals with centralized management,'' and established ''[p]ricing among the members of these pre-war groups almost certainly resembled pricing between independent companies acting at arm's-length, if only because existing technology didn't permit any other approach''; and the equation of the critique of arm's-length during the period of the ''great transfer pricing wars'' with U.S. ''minimum tax'' objectives.[168]

But then Durst, an early head of the IRS's APA office and officially a long-time supporter of arm's-length, surprised his audience with a change of view:

> Now, before addressing the Obama Administration's proposals, and again because of the nature of this particular audience, I should acknowledge that throughout the last 40 or so years, debate has continued among serious-minded people over whether the arm's-length system can, feasibly, be replaced, or whether it is instead the best of available evils. I plainly have formed my own views on this topic; I think that a more formulary approach, while subject to many difficulties, is not only feasible but would be much less problematic in administration than the current approach.
>
> Speaking here in Toronto, I should say that I am especially puzzled by the argument sometimes raised that moving away from arm's length, without raising undue double taxation conflicts, would require international agreement on a single formula, perhaps at a grand global Congress of Vienna — or, remembering the role of the League of Nations in our story, maybe a Versailles Conference — on international taxation. One needs only to look at the state of competent authority proceedings today, not only between the United States and Canada but around the world, to determine how well the arm's-length standard has fared in managing international disagreement, including double taxation. Under a formulary system, even if different countries used different formulas, there would at least be clear starting points for negotiation and compromise.[169]

Durst also reiterated what he and Culbertson had suggested six years earlier, with some reference to the work of the European Commission, about the softening of positions about fractional apportionment:

> Also, before moving on to the President's recent proposals, I should observe as background that the political positions of non-U.S. governments with respect to the arm's-length standard have, I think, changed at least somewhat since the mid-1990s. Today, not only companies in the high-tech areas, but also traditional brick-and-mortar companies, have learned the technique, through ''restructuring,'' of using the principles of the arm's-length standard to direct portions of their incomes to low-tax jurisdictions. Therefore, tax administrations that felt themselves immune to such techniques 15 years ago do not view themselves as immune today.
>
> If the issue of formulary versus arm's length were to come up again, it is not clear that governments around the world would be as adamant in supporting the traditional ''facts and circumstances'' approach as they were during the early 1990s. The continued — albeit sometimes faltering — consideration within the European Union of the Common Consolidated Corporate Tax Base proposal attests, I think, at least to some fluidity of views on this question.[170]

D. Avi-Yonah/Clausing/Durst Defense of Fractional Apportionment

In 2009, Durst joined Professors Avi-Yonah and Clausing in publishing an article setting forth and defending a statutory proposal for a formula apportionment system using sales as a single apportionment

[166] *See, e.g.,* 2009 *TNT* 84-47 (''CBPP Calls Obama's International Tax Proposal a 'Step Forward' '').

[167] *See, e.g.,* 2009 *TNT* 87-41 (''Heritage Says Obama International Tax Proposal Would Harm U.S. Competitiveness'') (5/5/09); 2009 *TNT* 84-45 (''Business Roundtable Says Obama International Tax Law Plan Will 'Cripple' U.S. Growth'') (5/4/09).

[168] Durst Presentation, 123 *Tax Notes* at 1269, 1271.

[169] Durst Presentation, 123 *Tax Notes* at 1272.

[170] Durst Presentation, 123 *Tax Notes* at 1272.

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factor.[171] The article largely restated the views expressed in the 2007 Hamilton Project paper.

In addressing the ''downsides of formulary apportionment,'' A-YCD identify five:

- The question whether formula apportionment is ''inherently arbitrary'';
- ''[I]mplementation issues associated with the definition of activities and the determination of the location of sales'';
- ''[P]roblems associated with interactions between countries with incongruent corporate tax systems'';
- Nonuniformity of accounting standards across countries, and the possible need for treaty modification; and
- The fact that ''some domestic industries and firms will find that their tax obligations will increase under the new system.''[172]

A-YCD argue that formula apportionment is no more arbitrary than arm's-length, given the possibilities arm's-length opens for shifting profits to low-tax ''base countries,'' which they say is ''a result . . . more arbitrary than consistently assigning profits to the market jurisdiction.'' [173] They then concede that ''any formula can produce arbitrary results in a given industry,'' but say that ''while some industries will lose under the proposed formula, others (such as major U.S. exporters) will win, and most taxpayers would gain from the increased simplicity and transparency of the FA regime,'' and then argue that ''[i]f companies are willing to pay one level of tax and are only concerned about double taxation, they should be willing to accept the FA option, which prevents double taxation but also double non-taxation.'' [174]

With regard to implementation, A-YCD focus on technical aspects of the single-factor system. A-YCD set forth a proposed statute that addresses in detail a number of subsidiary issues connected with their particular proposal, which involves, as does the residual profit split method of the present regulations, assigning returns to ''routine'' factors prior to apportioning residual profit, which under the A-YCD proposal is based exclusively on sales.

As to interactions between countries, A-YCD concede that it ''would be ideal for most major countries to coordinate implementation of FA and to come to a joint agreement on the definition of the formula for apportioning global income,'' but assert that ''[e]ven without formal cooperation, however, unilateral adoption by the United States of a reformed system for taxing international income would create a powerful incentive for other countries using separate accounting to adopt similar new systems.''[175] They set forth two arguments for this view.

First, they argue that in a ''world with both formulary and separate accounting system countries, formulary countries will immediately appear as tax havens from a separate accounting country perspective,'' because ''a multinational firm operating in both separate accounting and formulary countries would have an incentive to book all their income in formulary countries, as the tax liability in such countries does not depend on the income booked there, but rather the fraction of a firm's activities in that location.'' [176]

This argument may be clarified by an example. Suppose you have a two-country corporation with an integrated profit of 120, of which 100 is ''residual'' profit. One country is a formulary nation with a single-factor sales system, and in that country 60% of sales occur. Assume the ''routine'' profits are 10 in each country. The formulary country will inflexibly tax 70 of the profit regardless of what the other country does. This gives the company an incentive to report the entire 100 residual to the formulary country, leaving the arm's-length state to challenge its allocation of a profit of 10 to that country. This, of course, gives the company an opportunity to shelter 40 of profit without using a base country. So it gives the unilateral-formulary country leverage to pressure the other country to go along with its system.

Second, A-YCD argue that the U.S. has ''led the way'' in international tax in the past, citing the foreign tax credit, the CFC provisions, and the transfer pricing regulations, and argue that ''[i]t is quite possible that if the U.S. adopted the proposed formulary split, this would be another innovation that is widely copied, with or without explicit coordination.'' [177] In the end, however, A-YCD are forced to concede that if ''other countries do not follow suit (or follow suit much later), or if countries adopt different formulas, there is the potential for double or zero taxation,'' and that this is ''arguably, the largest obstacle to unilateral adoption of a formulary system.'' [178] Still, they say the significance of the obstacle ''should not be overstated,'' again emphasizing a comparison to the current regime. They argue finally that the political disputes likely to arise are apt to be most intense with respect to low-tax countries, not other high-tax countries, and that low-tax countries ''may find themselves in political alliance with multinational companies themselves.'' [179] They say that ''[h]ow to resolve the resulting controversy is a question that will need to be resolved by Congress — but the controversy

[171] A-YCD.

[172] A-YCD at 516–25.

[173] A-YCD at 516.

[174] A-YCD at 519.

[175] *Id.*

[176] *Id.*

[177] *Id.* at 520.

[178] *Id.*

[179] *Id.* at 521.

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should be recognized as primarily political in nature.'' [180]

With respect to nonuniformity and the definition of the tax base, A-YCD express the view that the system would work best with an internationally harmonized tax base — which they distinguish from harmonized rates, which they say parenthetically and without discussion would be ''unlikely as well as undesirable.'' [181] They note the movement in the U.S. toward the adoption of international accounting standards, suggesting that these standards could form the basis of a ''harmonized base,'' but then say that, in any event, if coordination could not be achieved, unilateral use of the U.S. definition of taxable income would provide a workable basis for the system. They also add recognition of concern about requiring ''the IRS to gain access to information on both U.S. and foreign multinational groups' operations outside the United States,'' which they dismiss by arguing that ''[c]urrent transfer pricing law, however, already requires access to such information, both in the application of the profit split method and in the course of examinations.'' [182]

In relation to tax treaties, A-YCD argue that while there is ''no question that historically, both Article 7 and Article 9 have been interpreted as incorporating 'arm's-length' concepts,'' [183] there is no reason ''why the United States and its treaty partners could not agree, under the 'competent authority' process . . . to interpret their treaties to accept the reformed apportionment approach as the closest feasible, and administrable, approximation to the 'arm's-length' results envisioned in Articles 9 and 7.'' [184] They argue that ''[e]xcept for low-tax, 'tax haven' countries, one would expect many if not most U.S. tax treaty partners eagerly to accept such an approach, since these treaty partners face the same difficulties in enforcement and administration of transfer pricing rules that the United States faces.'' [185] They reiterate that ''[p]olitical opposition to the reform from low-tax countries and from businesses that will pay relatively larger shares of the corporate tax burden must be respected and dealt with,'' but say ''such political opposition should be recognized for what it is.'' [186]

A-YCD cite studies showing that fractional apportionment would have disproportionate effects on different industries, raising taxes on oil companies, and lowering them, for instance, on firms relying more on export than direct foreign investment with regard to their international operations. A-YCD respond by arguing that negative impacts ''may be muted,'' because ''firms will benefit from reductions in complexity and compliance burdens,'' and ''accompanying the adoption of a more formulary system with a reduction in the corporate income tax rate would increase the number of firms benefiting from the adoption.'' [187]

XI. DIFFICULTIES WITH UNILATERAL ADOPTION AND THE SINGLE FACTOR SALES METHOD

A. The Single Factor Sales Method

1. Internalization Theory and the Choice of Factors

Two aspects of this proposal generate controversy among critics of arm's-length and supporters of fractional apportionment: the use of sales as a single factor, and the proposal for unilateral action. Fractional apportionment supporters who responded to the proposal tended to fuse the two,[188] but they should be separated, because they present some wholly separate issues. Moreover, this proposal is heavily influenced by the historical interpretation, especially of the history of the last 25 years, reflected in the Durst-Culbertson article and the Durst IFA presentation. The defects of the proposal may be linked directly to the deficiencies of that interpretation.

As to the use of sales as a single factor, the principal justification for it lies, I believe, in the developments I sketched above as pre-dating the fights over transfer pricing that began in the mid-1980s — specifically, the recognition that the conceptual underpinning of international tax policy was not capital export neutrality, but a ''classification and assignment'' system that essentially assigns primary taxing rights to the state from which the income in question is least likely to move in response to taxation. The principal justification for using a sales factor is that multinational corporations have assets, labor pools, and other income-producing factors that can be relocated in response to tax changes, but have markets that are largely fixed. On these assumptions, using sales as a single factor best assures tax ''neutrality,'' that pre-tax arrangements will remain unaffected by the imposition of tax.

2. Consequences of Ignoring the Distinction Between Internalization-Based Critique of Arm's-Length and ''Net Income Benchmarking''

That being said, there are many questions about using sales as a single factor, and these are related to the criticisms I set forth above, particularly about the Durst-Culbertson interpretation of the ''wars.'' The principal problem I identified with their interpretation was their elision of the period between the White Paper and the issuance of proposed regulations, and, related to that elision, their identification of the critique

[180] *Id.* at 521–22.

[181] *Id.* at 522.

[182] *Id.* at 523.

[183] *Id.*

[184] *Id.* at 524.

[185] *Id.*

[186] *Id.*

[187] *Id.* at 526.

[188] *See* Weiner, ''Redirecting the Debate on Formula Apportionment,'' *Tax Notes* (6/18/07) at p. 1164.

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of arm's-length with the notion they describe as ''net income benchmarking.'' In that interim period, we critics of arm's-length inquired into the nature of the ''economies of integration'' that give rise to multinational (integrated) form; and in doing so found justification for using both productive inputs (assets) and indices of destination (sales) as a basis for allocating integrated profit. By overlooking this element of the critique, and not recognizing distinctions between the genuine critique and ''net income benchmarking,'' A-YCD overlook considerations countervailing or limiting the idea of making allocations exclusively on the basis of the indices that are least easily changed.

Similar considerations apply to A-YCD's insistence that intangible assets be excluded from the calculation, as they are under most state systems. A-YCD assert that the value of the intangibles inheres in the entire organization, and therefore should be allocated according to otherwise applicable factors.[189] I have long insisted, in a related way, that it is incorrect to assume that the ''residual'' income of multinationals is always attributable to some identified set of rights that can meaningfully be called ''intangible property,'' or ''property'' at all; often there is no identifiable intangible, and the residual is really attributable in full to the ''fact of organization,'' in a sense taken from Alfred Marshall.[190] But this is not the same as A-YCD's argument; their argument rather assumes the converse of what I claim, that is, they seem to be saying it *never* makes sense to attribute the residual to a localizable ''intangible''; I merely state that it does not *always* make sense so to attribute it. It seems to me not only that ''assets'' should be used in any formula, in some proportion, but that assets should include specifiable, localizable intangible assets, if such are present and can be identified. And intangible assets can be reflected by ''intangible development costs,'' conceived as they were under the 1994 regulations before the 2006–09 amendments. I do not believe any final judgments on this point should be made, in any event, until more is known how the intangible development cost-based residual profit split method actually worked in the 1994–2006 period.

3. Problems with Trade Agreements

But the use of the single factor sales method suffers from more serious defects, and these have a direct relationship to the error of associating opposition to arm's-length with support of ''net income benchmarking.'' And these defects are considerably more serious when the method, which rewards importer nations with additional claims to revenue, is suggested as a unilateral action for the U.S., a net importer for the past 50-plus years. Thus, it sounds of the same theory that underlies ''net income benchmarking'' (and that grows out of the recognition of a ''motility''-based system of assigning taxing rights): they are our markets; we have a right to tax the income generated in them. For this reason, the unilateral adoption of that method might stir reactions more like those stirred by ''net income benchmarking'' than those A-YCD wistfully forecast. In the example given above, for instance, the separate accounting state might anticipate deliberate underreporting by multinationals operating in (and overreporting to) fractional apportionment states, and, instead of falling in line by adopting fractional methods it thinks disfavors itself, might begin aggressive, even assembly-line audits and adjustments of multinationals.

4. Problems with September 2009 G-20 Accords and Reduction of U.S. Dependence on Imports

For that matter, as A-YCD in part recognize, the single factor sales method might violate international agreements other (and in some sense more important) than income tax conventions. Fractional apportionment is often said to be little more than an excise tax on the factors used to make the apportionment. Under this theory, the tax on the income allocated under the single factor sales method begins to look like a tariff, which might violate General Agreement on Tariffs and Trade or World Trade Organization rules. Since publication of the A-YCD article, the Group of 20 nations agreed informally to address global economic imbalances: that the United States would seek to enhance its savings rate and reduce its trade deficit; China, Japan, Germany, and other export-driven economies would attempt to increase domestic consumption and reduce their trade surpluses.[191] Unilateral adoption of the single factor sales method would reward the United States for its trade deficit with additional base upon which to impose corporate income tax; at a minimum, this is not consistent with the Group of 20 accord reached in Pittsburgh in September 2009.

B. Unilateral Adoption

As to the question of unilateral action, the A-YCD proposal is quite suspect, and its lurking problems relate to several of the inaccuracies of the historical account to which the proposal is linked. These include the false, undocumented proposition that ''in the beginning'' multinationals operated like a collection of separate enterprises, and ceased to do so only when communication and transportation facilitated centralization of management — an apparent fabrication spelled out at extended length in Durst's IFA presentation.[192] It includes the emphasis throughout the Durst-Culbertson article on interpreting historical events as fights over revenue concerns, when in fact an examination of the conflicts strongly suggests that other concerns — especially disclosure, ''transparency,'' and the overall relationship of business and government — are at the root of the acrimony. And, a related point but perhaps the most important one, it includes the minimization of the general political sig-

[189] A-YCD at 540.

[190] Langbein, ''Transaction Cost, Production Cost, and Tax Transfer Pricing,'' *Tax Notes* (9/18/89) at p. 1391, 1411.

[191] Andrews, ''Leaders of G-20 Vow to Reshape Global Economy,'' *New York Times* (9/26/09) at p. 1.

[192] *See* Durst Presentation, 123 *Tax Notes* at 1269.

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nificance the issue assumed in the 1990s, and the relationship of the Clinton Administration's abandonment of transfer pricing reform to its overall approach to shaping the international economy in the wake of the collapse of the Soviet economy.

1. Unilateral Adoption and the Role of Transfer Pricing in the Definition of "Borders" of Public and Private Authority

When all of those matters are taken into account, most elements of A-YCD's defense of unilateralism seem born of a childlike naivetë. Begin with their argument, spelled out at numerous points, that the political conflict would likely be not with high-tax countries, which had revenue concerns similar to ours, but only with low-tax countries, allied with affected companies. This argument flows directly from understanding the history of this matter as primarily an issue of revenue. But that understanding is flawed; there appears to be much more at stake, touching the basic relationship, and distribution of powers, between governments internationally and their powerful private sector counterparts. When these latter matters are taken into account, what can be expected of the governments of foreign, high-tax countries stands in a starkly different light. This influences the forecasts these authors make concerning the question of the treaty compliance of their suggested method, the problem of double taxation and the response of separate-accounting countries to the unilateral fractional method, and the likelihood of developing a uniform international base.

2. Unilateral Adoption and the Problems of Transparency and Information Gathering

These considerations also destroy, I think, their response to the question of concerns about international information gathering. It is true that under the current transfer pricing regimes, under *some* methods, reporting of worldwide financial information is required. But the taxpayer may avoid this by defending methods that do not require it, and one suspects that the relative disuse of the profit split method, in the face of what a careful reading of at least the regulations as in effect from 1994 to 2006 would suggest, bears some relationship to taxpayer efforts to avoid the necessity of disclosing worldwide information. Taxpayer reaction, and the reaction of foreign governments responsive to the concerns of their large corporate citizens, is likely to be quite different in response to a system that *requires*, in all cases, worldwide information reporting.

3. The Role of Compliance Cost and Professional Intermediaries as "Interest Groups"

And a clear understanding of the history of transfer pricing, particularly the ''wars,'' similarly demolishes A-YCD's hope that taxpayers acting as interest groups will restrain opposition to the proposal on account of reduced complexity and compliance costs. Complexity and compliance costs have attended the system for 40 years, without sparking substantial taxpayer complaint. Indeed, in my original article on this subject, one of my paramount concerns with the ambiguity of the system was the possibility of oppressive use of the rules by the government against private enterprise, a concern then suggested by the Marc Rich prosecution.[193] That concern never generated any business support, in part, possibly, because the business community recognized that the ambiguity and pliability of the rules — and the quondam susceptibility of instrumentalities of government — could also be used as weapons in severe business competition and battles.

In large corporate and financial matters, business and the intermediaries who impose the compliance costs (investment bankers, lawyers, accountants) often are aligned politically even where they are on the opposite side of the table, considering the professional fees that constitute the lion's share of the costs. This pattern can be seen with respect to the Service's campaign against tax shelters in the recent decade. The IRS has prevailed in litigation generally with respect both to shelters marketed primarily to individuals [194] and to those marketed to corporations.[195] In the former cases, the banks, law firms, and accounting

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[193] Langbein, *Unitary Method*, at 666:

> Finally, while I do not want to overemphasize the point, and while I again stress I am not accusing anyone of anything, a schizoid regime like ''arm's length'' makes the imposition of an unjust (civil or criminal) penalty ultimately on someone somewhere inevitable.

[194] *E.g.*, *Klamath Strategic Investment Fund, LLC v. U.S.*, 568 F.3d 537 (5th Cir. 2009); *Kornman & Associates Inc. v. U.S.*, 527 F.3d 443 (5th Cir. 2008); *Cemco Investors LLC v. U.S.*, 515 F.3d 749. These decisions have involved ''son of BOSS'' structures described and attacked by the Service in Notice 2000-44, 2000-2 C.B. 625, which appears to be the principal form of shelter designed for individuals which the Service extensively and vigorously litigated. There are numerous district court decisions upholding the IRS's position. The Service lost one ''son of BOSS'' case in the district courts, *Sala v. U.S.*, 552 F. Supp. 2d 1167 (D. Colo. 2008), a case exhibiting special circumstances, but won it on appeal. No. 08-1333, 10th Cir. 7/23/10.

[195] *See, e.g., BB&T Corp. v. U.S.*, 523 F.3d 461 (4th Cir. 2008) (''lease-in/lease-out'' (LILO) transaction); *TIFD III-E, Inc. v. U.S.*, 459 F.3d 220 (2d Cir. 2006) (''Castle Harbor''); *Coltec Indus., Inc. v. U.S.*, 454 F.3d 1340 (Fed. Cir. 2006) (''contingent liability'' shelter); *Black & Decker Corp. v. U.S.*, 436 F.3d 421 (4th Cir. 2006) (''contingent liability'' shelter). The Service won early victories in litigation against the so-called ''contingent installment sale shelter,'' promoted by Merrill Lynch, which involved manipulation of Regs. §15A.435-1(c)(3)(I). *ACM Partnership v. Comr.*, 157 F.3d 231 (3d Cir. 1998); *Boca Investerings Partnership v. U.S.*, 314 F.3d 625 (D.C. Cir. 2003); *ASA Investerings P'ship v. Comr.*, 201 F.3d 505 (D.C. Cir. 2000). This ''shelter'' was designed for large corporations.

But the *ACM* victory was followed, and the subsequent contingent installment sale victories accompanied, by a string of three defeats for the Service, two involving so-called ''foreign tax credit stripping'' transactions. *Compaq Computer Corp. v. Comr.*, 277 F.3d 778 (5th Cir. 2001); *IES Indus. Inc. v. U.S.*, 253 F.3d 350 (8th Cir. 2001); *UPS of America v. Comr.*, 254 F.3d 1014 (11th Cir. 2001). These defeats involved the so-called ''economic substance'' doctrine, and after *Compaq*, *IES*, and *UPS*, it appeared the Service would have a difficult time sustaining its position against

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firms that designed the shelters have faced extensive litigation by taxpayers who have had to pay back taxes.[196] There is little such litigation by corporate taxpayers against their advisers; only rarely do adverse outcomes affect these relationships. The pattern of adviser-taxpayer alignment — where taxpayers or other ''tax-affected'' parties accept large sacrifices, even in terms of revenue (which is, after all and as noted above, only money), to support a community of adviser/intermediaries with whom those taxpayers have alignments — is evident, too, in the evolution and development of policy regarding Build America Bonds (BABs) under the American Recovery and Reinvestment Act of 2009 (''ARRA'').[197]

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the shelters, at least under the ''economic substance'' doctrine, which the Service viewed as its primary weapon in the campaign. The IRS enjoyed considerable success in the district courts and the Federal Claims Court against the ''son of BOSS'' shelters, and in some other shelter litigation; these, as noted, involved shelters designed for wealthy individuals. But then, in 2006, the Service won a landmark string of victories invoking ''economic substance'' against corporate shelters, in *Black & Decker*, *Coltec*, and *Castle Harbor*, all of which (*Coltec* in particular) rested upon particularly stringent statements of the ''economic substance'' doctrine. This was followed in 2008 with *BB&T*, in which the Service prevailed against a ''lease in/lease out'' shelter, which, perhaps of all the ''corporate tax shelters,'' troubled the private bar the most, because of the difficulty of distinguishing the transaction from a range of ''leveraged lease'' transactions which have long been unchallenged, if indeed they have not been accepted, by the Service. This was followed by a number of victories against related ''sale-in/sale-out'' (SILO) shelters. *Wells Fargo & Co. v. U.S.*, 91 Fed. Cl. 35 (2010); *Altria Group, Inc. v. U.S.*, 105 A.F.T.R. 2d 1419 (2010); *cf. Consolidated Edison Co. v. U.S.*, 90 Fed. Cl. 228 (Fed. Cl. 2009).

Yet there is no indication of any litigation brought by corporate taxpayers who lost these decisions against advisers who recommended the transactions.

[196] This litigation has been legion, especially with respect to ''son of BOSS'' structures, see Notice 2000-44, 2000-2 C.B. 625. There are few reported decisions, owing mostly to the fact that the litigation has tended to result in settlements between the clients and their advisers. There are numerous reported decisions, however, with respect to issues that arise in the course of litigation, and on two occasion matters occasioned by arbitration clauses in connection with this tax shelter litigation reached the Supreme Court. *Arthur Andersen LLP v. Carlisle*, 129 S. Ct. 1896, 173 L. Ed. 2d 832 (5/4/09); *Wachovia Bank v. Schmidt*, 546 U.S. 303 (2005).

[197] P.L. 111-5, §123. BABs are bonds issued by state and local governments, which are fully taxable, but as to which the federal government makes a payment to the issuer to reimburse the issuer for 35% of the interest cost on the bond, originally limited to certain types of issues and to bonds issued in 2009 and 2010. The provisions governing them are codified at §§54AA and 6431. The first BABs were issued in April 2009, shortly after the enactment of ARRA, and immediately questions were raised about the pricing of the bonds. The difficulty stemmed from the fact that the 35% payment was in excess of the ordinarily prevailing difference between taxable and tax-exempt rates. Assume, for instance, that the prevailing taxable and tax-exempt rates are 7% and 5.5%, respectively. If a municipality issues BABs at the taxable rate, it gets a subsidy of 2.45%, reducing its after-subsidy yield to 4.55%, well below the tax-exempt yield. It turned out, however, in the early deals, that the state and local issuers were happy to receive *any* rate that was lower than the tax-exempt rate. Thus, for instance, in the example, they would accept an after-subsidy rate of 5.2%, 100/65 of which is 8%. This enabled investment bankers to secure bonds for a price reflecting an 8% return, and immediately to ''flip'' the bond in a secondary market, where the price reflected the ordinary taxable yield (7% in the example). *See generally* Langbein, ''Bloody BABs: Tax-Exempts, the Stimulus Act, and Obama Tax Policy,'' *Tax Notes* (6/22/09) at p. 1449, 1456 & nn. 50–51; Preston and Keogh, ''Taxpayers Lose $328 Million in Build America Profits (Update 3),'' available at http://www.bloomberg.com/apps/news?pid=20601109&sid=a6BUiSZsDKqo&refer=home (last visited May 5, 2009). This meant a large and immediate profit — at times equal to 8% to 10% of the face amount of the bonds, virtually overnight — either to the underwriters or first purchasers of the obligations.

My initial reaction to this situation was that it would be temporary; that state and municipal issuers would eventually (soon) ''catch on,'' and demand the best rate they could achieve. This did not happen, however, and for something of a funny reason. See McDonald, ''Building America With Obama Bonds Signals Munis' Fall,'' http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aQqI3SKPm.t4 (6/25/09)); Quint and McDonald, ''Even Mayor Daley Can't Get Rates Taxpayers Deserve for Chicago,'' http://www.bloomberg.com/apps/news?pid=newsarchive&sid=abDvAmLrju6A); Preston, ''Dallas Hospital Sells Largest AAA Build America Bond,'' http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ag9S5KNtxQR4).

What was funny stemmed from the existence of a large community of intermediaries — banks, investment banks, lawyers, accountants — who constitute what one might call a ''tax-exempt bond'' industry (this is an ''interest group,'' in terms of ''interest group theory,'' discussed above. This ''interest group'' and its participants were horrified at first by the BABs proposal, because the generosity of that proposal promised issuers a *lower* cost than ordinary tax-exempts: the fear was that BABs were a ''foot in the door'' toward abolition of the tax exemption, and its replacement with a BABs-type subsidy. Treasury officials and congressional staffers repeatedly and emphatically sought to reassure the tax-exempt bond community that this was not the intention of the legislation — that the BABs provision was temporary, and the historic exemption was not going away. *See, e.g.,* 2009 *TNT* 188-5 (''Ways and Means Tax Counsel Denies Exempt Financing Is Threatened'') (9/30/09). But the pressure to extend this assurance, and to forestall opposition to the whole program by a large and powerful ''compliance'' community, led the government to tolerate the form of ''flipping'' described above — and of deliberate underpricing of the issues — because it meant that the all-in cost of BABs was not much different from the cost of ordinary tax exempts, and thus mitigated the threat to the ''ordinary'' municipals market that BABs originally had appeared to pose.

This situation could not go on forever. In the second session of the 111th Congress, the ''jobs bill'' provided a BABs-type subsidy to four categories of bonds that had been so-called ''tax credit'' bonds — bonds on which the issuer pays no interest but allow the holder to claim tax credits equal to the amount of interest that would have been paid had the bond been issued at a taxable rate (with the credit includible in income). These provisions, however, limited the payment Treasury made to a portion of the interest payable at the *lower* of the actual rate on the bonds or a Treasury-

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C. Transfer Pricing and the Resolution of International Issues Raised by the Financial Crisis

Nor do the claims of A-YCD concerning past instances of U.S. ''pioneering'' in the international tax area dispel these concerns. A-YCD cite three instances where they allege that the international community emulated U.S. innovations: the foreign tax credit, CFCs, and the transfer pricing rules. While I would concede the latter two instances, I believe the first to be poorly documented. In any event, there are innumerable other instances, many of recent vintage, where other nations have at best ignored and at worst attacked U.S. innovations: domestic international sales corporations (DISCs); branch profits taxes; foreign sales corporations (FSCs); repeal of withholding tax on portfolio interest; imposition of withholding requirements on qualified intermediaries; private foreign investment companies (PFICs), among many others. And whatever the proclivities of U.S. trading partners to emulate our practices in the 1920s or 1970s, one suspects those proclivities have weakened in the face of economic expansion throughout the world, especially in developing economies, especially in ''emerging markets,'' to say nothing of the implosion of U.S. mortgage and financial markets and the ensuing international financial crisis and ''great recession'' of 2007–08.

The fundamental difficulty I have with recent scholarship advocating formula apportionment, and detailing or depending upon a history of the 1985–95 ''transfer pricing wars,'' is its treatment of the matter as distinct, even isolated, from other, larger issues of international tax and economic policy. Concededly, this is a characteristic that to some extent afflicts tax scholarship generally. But, as I think I have shown above, the developments in transfer pricing between 1985 and 1995 cannot be fully or well understood without reference to contemporaneous currents in thought and policy about international economic matters generally.

This is especially important at the present time in which the recent ''financial crisis'' has raised issues requiring continued close international cooperation. The pressure on institutions for such cooperation is likely to intensify. The near collapse of major financial institutions worldwide has entailed costly government bailouts of the institutions, and the economic retrenchment that ensued in the wake of this near collapse has led to costly government efforts to stimulate domestic economies. These in turn have generated twin policy problems: first, the growing problem of government budget deficits and debt levels, raising questions of integrity of sovereign debt; second, the search for institutional reform that will prevent similar crises in the future, and will obviate the need for similar government bailouts.

In the U.S., in particular, the deficit problem has led to the creation of a Presidential commission searching for a set of proposals that will reduce and control budget deficits. The examination of this problem will almost certainly give consideration to international tax avoidance, through ''harmful tax competition,'' abuse of tax havens, and other matters.[198] This is so because the area appears to present the opportunity to collect substantial revenues.

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mandated rate approximating a comparable taxable rate. *See* Schroeder, ''Obama Signs BABified Jobs Bill,'' *The Bond Buyer* (3/19/09). This puts some limit on ''flipping.'' Furthermore, the original statute limits the amount of ''premium'' that BABs may carry, and the ''flipping'' practice raises questions about what constitutes the ''issue price'' of the bonds, in turn raising questions about whether the bonds bear an impermissible amount of premium. The Service has said it is exploring this issue. *See* McNichol, ''New Jersey Flips BABs as IRS Scrutinizes Market,'' http://www.bloomberg.com/apps/news?pid=newsarchive&sid=axRexrmESKjw (4/15/09) (last visited Apr. 17, 2010). And the communities involved in pricing the issues are increasingly nervous. Schroeder, ''Groups Consider Asking for Clarification on BABs Prices,'' *The Bond Buyer* (4/26/10) at p. x.

My point here is that the entire episode underscores the existence of important alignments between a community affected by the tax law, a ''tax-affected community'' (here the issuers), which constitutes one ''interest group'' (which here happens to consist of public entities), on the one hand, and what I am calling a ''compliance community'' (here the tax exempt bond industry), a linked but separate and distinct interest group, on the other. This episode illustrates dramatically, I think, that the preservation of alignments between ''tax-affected communities'' and ''compliance communities'' may sometimes be sufficiently important to the tax-affected community, that, that community is willing to tolerate not only very substantial ''compliance'' or ''administration'' costs rather than risk a split with its ''compliance community'' allies; but also to tolerate high costs in terms of revenue or taxes paid to the government, or savings foregone, in order to serve and preserve longstanding alignments.

[198] On Feb. 25, 2010, Rep. Richard Neal of Massachusetts, Chair of the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, announced that the Subcommittee would conduct a study of transfer pricing this year. The announcement was made at the Tax Policy Council's 11th annual Practice and Policy Symposium in Washington. Rep. Neal said at the same time there are no plans for further steps, such as hearings or the proposal of legislation. 2010 *TNT* 38-3 (2/26/10). On July 22, 2010, the Ways and Means Committee held a hearing on ''Transfer Pricing Issues.''

In addition, as noted above, the Administration in its 2011 budget added a proposal concerning transfers of high-profit intangibles to low-tax countries to the international proposals set forth in the 2010 budget. This proposal is not intended to affect transfer pricing rules, but it certainly touches an area near the heart of contemporary concerns about the transfer pricing rules.

For discussion during the height of the financial crisis of the potential impact of the crisis on the transfer pricing situation, see ''Downturn Adds Intensity to Transfer Pricing Scrutiny, Says Practitioner,'' 2009 *TNT* 190-7 (10/2/09) (report of statements of David Canale, director of transfer pricing controversy services for Ernst & Young, in Oct. 1, 2009 interview with Tax Analysts concerning global survey conducted by E&Y); ''Down Economy Changes Approach to Transfer Pricing Analysis, IRS Economist Says,'' 2009 *TNT* 8-16 (1/13/09) (remarks of Michael Aarstol head of the IRS advance pricing agreement (APA) program's San Francisco office, at a January 10 panel at the American Bar Association Section of Taxation meeting in New Orleans).

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With respect to financial reform, the area is also certain to test the capacity of the international community to address some of the larger issues I have here suggested afflicted the transfer pricing controversy in the early 1990s, namely, the tensions between decentralized Anglo-American and more centralized Euro-Japanese capitalism. In a recent column, titled ''Financial Reform 101,'' Professor Paul Krugman, also a *New York Times* columnist, suggested that proposals for reform took one of two basic tracks.[199] One, which Professor Krugman identified with former Board of Governors Chair Paul Volcker, advocates breaking up large financial institutions into smaller pieces. The second, to which Professor Krugman states he himself subscribes, focuses instead on leaving such institutions intact, but subjecting them to greater regulation.

My own judgment on this general issue is that, from the standpoint of domestic policy viewed in isolation, the first course, the Volcker course, is the preferable one; but that, as a practical matter, it is one that is unavailable, because it will never be susceptible to coordination with the policies of other major nations. European nations have already made clear that they would not go along with the ''Volcker rule'' proposed by the Obama Administration, for separating proprietary trading activities from deposit-taking activity.[200] And U.S. bank policy, from the late 1980s forward, in both Democratic and Republican administrations, has been driven by many of the same general conceptions as drove the reaffirmation of arm's-length in the 1990s: the decision to coordinate (and subordinate) the more decentralized features of the American economy to the more centralized forms of free enterprise prevailing in Europe, Japan, and, more lately, in the emerging economies.[201]

Unlike the fiscal problems presented by international tax, however, it would seem the need for financial reform, particularly reform designed to mitigate the possibility of future bailouts, is a more urgent one, both economically and politically, and thus one not likely to be swept under the rug in large or small ways. And I believe some of the tensions about ''globalization'' policy will be resolved, or at least revealed, by the process of addressing them. Thus, I believe that a future examination of transfer pricing policy, which appears to be on the horizon, should await attempts by the international community to address the more immediate problems of financial reform.

The resolution of current issues is likely to take one of two courses, either of which suggests the eventual demise of arm's-length. Even should the international community commit itself, as it has to date, to continuing the policies of the last 20 years, of encouraging ''globalization'' through promoting the dominance of large, privately controlled institutions, the result for corporate taxes is likely to be either a continuation of substantial reductions in corporate tax rates in the world, or the outright abolition of the corporate tax. Either would greatly diminish the importance of transfer pricing generally.

Should the international community, on the other hand, and as appears more likely, decide to modify or abandon the course of policy over the last 20 years, asserting greater government control over large private enterprises and the private economy, and offering greater protections to consumers, individuals, and smaller, less integrated businesses, then it is likely to retain and strengthen the corporate income tax. If it does this, it will almost certainly have to address the issue of transfer pricing, and will almost certainly have to come to terms with the deficiencies of the putative international ''arm's-length'' norm. It will then have to address other international tax issues, including harmful competition and even base and rate ''coordination.'' And it is in that context that the development of procedures and norms for introducing formula apportionment can best proceed.

[199] *New York Times* (4/2/10) at p. 23.

[200] *See* Vandore, Associated Press, ''EU Keeps Eye on U.S. Financial Regulation Bill'' (4/21/10) available at http://www.google.com/hostednews/ap/article/ALeqM5htax-OSnaxoccLtrepd0TEA1VupQD9F7IMH00 (last visited 5/3/10); Thesing and O'Brien, ''ECB's Weber Says Volcker Rule Has 'Significant' Shortcomings,'' http://www.bloomberg.com/apps/news?pid=newsarchive&sid=apw5_SIOhgsE (last visited 5/3/10) (statement of Alex Weber, member, European Central Bank, and head of Germany's Bundesbank).

[201] *See generally* Langbein, ''The Thrift Crisis and the Constitution,'' 53 *Wash. & Lee L. Rev.* 159, 167–170 (1996).

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