

# INTERNATIONAL TRANSFER PRICING AND THE ELUSIVE ARM'S LENGTH STANDARD: A PROPOSAL FOR DISCLOSURE OF ADVANCE PRICING AGREEMENTS AS A TOOL FOR TAXPAYER EQUITY

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I. INTRODUCTION .....	207
II. THE CURRENT PROBLEM WITHIN THE TRANSFER PRICING COMMUNITY: A LACK OF COMPARABLES .....	210
A. <i>Best Method Rule</i> .....	212
B. <i>Price at an Arm's Length</i> .....	215
C. <i>Lack of Data and Penalties for Non-Compliance</i> .....	219
III. DISCLOSING APAS WOULD BENEFIT THE TRANSFER PRICING COMMUNITY .....	221
IV. SOLVING THE ISSUE OF PROPRIETARY INFORMATION AND TRADE SECRETS .....	227
V. CONCLUSION .....	230

## I. INTRODUCTION

Transfer pricing disputes involve jarring amounts of money. In 2014, the Internal Revenue Service (“IRS”) squandered \$2.2 million in an unsuccessful investigation into Microsoft’s tax practices.<sup>1</sup> Again, in 2017, the billion-dollar multinational corporation, Amazon, prevailed in a transfer

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1. David Forst & Larissa Neumann, *US Transfer Pricing Litigation Update*, INT’L TAX REV. (Mar. 26, 2015), <http://www.internationaltaxreview.com/Article/3440036/US-transfer-pricing-litigation-update.html>.

pricing dispute with the IRS that otherwise could have cost the company more than \$3 billion in taxable income.<sup>2</sup> The IRS's 2013 Apple investigation provides yet another instance of high-stakes transfer pricing disputes. In that case, the Senate Permanent Investigations Subcommittee ultimately discovered that Apple had reduced its U.S. corporate income tax by an estimated \$1 million on its overall \$22 billion in earnings.<sup>3</sup> Why does the IRS continually fail to convince the United States Tax Court that mammoth multinational corporations such as these evade their respective tax obligations? Put simply: transfer pricing.

Transfer pricing occurs when related multinational entities engage in mutual trade.<sup>4</sup> Companies allocate taxable income to low-tax jurisdictions and tax-deductible costs to high-tax jurisdictions. In addition, multinational entities shift profits by selling component parts and final goods between subsidiaries at inflated or deflated prices.<sup>5</sup> While the term "transfer pricing" itself is tax neutral, it is essentially equated with tax avoidance or profit shifting from a high-tax jurisdiction to a lower tax jurisdiction.<sup>6</sup> For example, in 2016, the IRS slapped Facebook with a tax deficiency notice of \$3 to \$5 billion after the multinational corporation transferred its global operations, an intangible asset, to an Irish subsidiary.<sup>7</sup> The IRS claimed that Facebook

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2. Julie Martin, *Amazon Wins \$1.5 Billion Transfer Pricing Dispute in US Tax Court*, MNE TAX (Mar. 24, 2017), <https://mnetax.com/amazon-wins-transfer-pricing-case-tax-court-20243-20243>.

3. *Offshore Profit Shifting and the U.S. Tax Code, Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Sec.*, 113th Cong. 10 (2013) (statement of Sen. John McCain, Member, Subcomm. on Investigations) [hereinafter *Permanent Subcomm. Report*], <https://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf> (explaining that, from 2009 to 2012, one Apple entity (ASI) "contributed a little more than half of the cost-sharing payments to Apple Incorporated but pocketed twice the earnings of Apple Incorporated, \$74 billion compared to \$39 billion. Apple Operations International received \$30 billion in dividends from 2009 to 2012 and paid zero taxes; \$102 billion of Apple's \$145 billion in cash on hand is overseas"); Howard Gleckman, *The Real Story on Apple's Tax Avoidance: How Ordinary It Is*, FORBES (May 21, 2013, 4:58 PM), <https://www.forbes.com/sites/beltway/2013/05/21/the-real-story-about-apples-tax-avoidance-how-ordinary-it-is/#152548336523>.

4. *Transfer Pricing*, TAX JUST. NETWORK, <http://www.taxjustice.net/topics/corporate-tax/transfer-pricing/> (last visited Sept. 4, 2018).

5. ORG. FOR ECON. CO-OPERATION AND DEV. [OECD], OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 320 (2017) [hereinafter OECD TRANSFER PRICING GUIDELINES], [https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017\\_tpg-2017-en#page1](https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page1).

6. *Id.*

7. Kartikay Mehrotra, *Facebook Tax Bill Over Ireland Move Could Cost \$5 Billion*, BLOOMBERG (July 28, 2016, 4:08 PM), <https://www.bloomberg.com/news/articles/2016-07-28/facebook-gets-3-5-billion-irs-tax-notice-over-ireland-move>.

deliberately shifted its profits to a lower tax jurisdiction and thereby seriously devalued its assets by billions of dollars.<sup>8</sup>

While transfer pricing permeates the international commercial community, its impact reaches much further than international trade. Returning to the Apple case, when the company created two entities in Ireland, it allocated \$22 billion of its \$34 billion pre-tax income.<sup>9</sup> Apple had a strong motivation to disproportionately allocate this income because, in 2011, Ireland maintained a 12.5% corporate tax rate while the U.S. maintained a 35% tax rate, one of the highest tax rates among developed countries at the time.<sup>10</sup> Though the Tax Court found for Apple, the Permanent Subcommittee's report reached a more disturbing conclusion: In the realm of tax avoidance, Apple's practices were not only typical of other multinational corporation, but the company was far from the worst multinational corporation in terms of intentional transfer pricing.<sup>11</sup>

A 2009 Christian Aid report substantiated the Subcommittee's finding, estimating that less developed countries lose approximately \$160 billion in tax revenue each year due to profit shifting and multinational corporation tax avoidance schemes.<sup>12</sup> Developing countries, such as India, Namibia, and Vietnam, particularly need these tax revenues to improve infrastructure, healthcare, and education.<sup>13</sup> Specifically, if spent on healthcare, the additional tax revenues would save 350 thousand children every year.<sup>14</sup> However, because half of world trade occurs through tax havens, and because

8. *Id.*

9. Gleckman, *supra* note 3.

10. Danielle Kurtzleben, *FACT CHECK: Does the U.S. Have the Highest Corporate Tax Rate in the World?*, NRP (Aug. 7, 2017, 10:09 AM), <https://www.npr.org/2017/08/07/541797699/fact-check-does-the-u-s-have-the-highest-corporate-tax-rate-in-the-world>; *Permanent Subcomm. Report*, *supra* note 3, at 2 (statements of Senator Carl Levin, Chairman, Subcomm. on Investigations); Gleckman, *supra* note 3.

11. *See Permanent Subcomm. Report*, *supra* note 3, at 14 (statement of Richard Harvey, Professor, Villanova University School of Law) ("Now, the scary thing is Apple allocated 64 percent of its global income into that shell corporation. There are other multinationals that probably would have allocated even more. So, to some extent, Apple is not as aggressive as others[.]"); Gleckman, *supra* note 3.

12. CHRISTIAN AID, FALSE PROFITS 3 (2009), <https://www.christianaid.org.uk/sites/default/files/2017-08/false-profits-robbing-the-poor-to-keep-rich-tax-free-march-2009.pdf>.

13. *Id.* at 6, 12-13, 23.

14. CHRISTIAN AID, DEATH AND TAXES 2, 51 (2008), <https://www.christianaid.org.uk/sites/default/files/2017-08/death-and-taxes-true-toll-tax-dodging-may-2008.pdf>.

businesses intend to avoid taxes, these developing countries likely will not receive the additional revenues any time soon.<sup>15</sup>

This Comment argues that Advance Pricing Agreements (“APA”), also known as agreements with taxing authorities that identify which transfer pricing methodology a company should use,<sup>16</sup> must be published and available to the public so that taxpayers understand how to comply with the required “arm’s length standard.” Section I, above, introduced the concept of transfer pricing. Section II addresses how the current lack of comparables in the transfer pricing community prevents multinational corporations from complying with the arm’s length standard. Section III then discusses how implementing a system of disclosure through use of APAs can combat companies’ inadvertent and perhaps even inevitable non-compliance with this standard. Finally, section IV responds to the argument that proprietary information and trade secrets need protection.

## II. THE CURRENT PROBLEM WITHIN THE TRANSFER PRICING COMMUNITY: A LACK OF COMPARABLES

Profit shifting has serious national and international consequences. As such, to combat profit shifting, both the IRS and the Organisation for Economic Co-Operation and Development (“OECD”) have implemented the arm’s length standard and require companies to charge a price as if the transaction were at arm’s length.<sup>17</sup> In essence, this arm’s length standard requires related companies to establish a transfer price comparable to transfer prices between unrelated companies<sup>18</sup> – that is, a fair price that is neither inflated nor deflated. The OECD implements this arm’s length standard through various methodologies, each of which apply appropriately to different situations.<sup>19</sup> As this section will illustrate, comparability lies at the heart of the transfer pricing methodologies.<sup>20</sup>

Yet, as it stands currently, there is a lack of public information for companies to compare.<sup>21</sup> In the U.S., the IRS operates under Internal Revenue Code (“IRC”) § 482, which establishes an arm’s length standard to

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15. *Id.* at 2, 52-55.

16. OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 214.

17. See CHRISTIAN AID, FALSE PROFITS, *supra* note 12, at 52; John Neighbour, *Transfer Pricing: Keeping it at Arm’s Length*, OECD OBSERVER, [http://oecdobserver.org/news/archivestory.php/aid/670/Transfer\\_pricing:\\_Keeping\\_it\\_at\\_arms\\_length.html](http://oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html) (last updated July 3, 2008).

18. See OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 33-36.

19. *Id.* at 35, 43-45.

20. *Id.* at 16.

21. *Id.* at 13.

govern income and deduction allocations for transactions between related parties.<sup>22</sup> In the international context, the OECD implements transfer pricing guidelines that lay out the arm's length standard and its methodologies.<sup>23</sup> Under the IRS regulations and the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("Guidelines"), transactions must satisfy two requirements: (1) the transaction price must be calculated using the best method under the circumstances, and (2) the price must meet the arm's length standard.<sup>24</sup> However, data is key to comparability.

Despite an available standard and established methods to implementing this standard, multinationals still experience audits and penalties for tax deficiencies.<sup>25</sup> The problem lies in the elusive arm's length standard. One solution by which multinationals can avoid audits and penalties is the use of APAs. Some multinationals opt for the APA alternative because it offers peace of mind and a no-audit guarantee.<sup>26</sup> In the U.S., the IRS does not publish APAs. As a result, multinationals and the public remain in the dark as to what the IRS finds acceptable and what it considers common practice. Without published APAs, watchdog groups expect the worst and multinationals wonder whether their competitors are getting a better deal. Although the IRS and OECD have both established an arm's length standard

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22. I.R.C. § 482 (1954) (stating, in part, that "[i]n any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property . . . , the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible").

23. See generally OECD TRANSFER PRICING GUIDELINES, *supra* note 5.

24. See 26 C.F.R. § 1.482-1(b) (2017).

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

*Id.* Phrased in slightly different terms, the OECD Guidelines state that the arm's length principle "is based on a comparison of the conditions in a controlled transaction with the conditions that would have been made had the parties been independent and undertaking a comparable transaction under comparable circumstances." OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 43. The analysis first requires evaluating "the commercial or financial relations between the associated enterprises and the conditions and economically relevant circumstances attaching to those relations." *Id.* The second aspect of considers whether "the pricing of that controlled transaction under the arm's length principle." *Id.* at 44.

25. See, e.g., Martin, *supra* note 2.

26. *Id.* at 476-80.

to govern transfer pricing, these standards experience limited success due to a lack of comparables.<sup>27</sup>

### A. Best Method Rule

The OECD's arm's length standard requires a fact specific inquiry into whether the method employed was the best method under the circumstances.<sup>28</sup> This is known as the Best Method Rule. The chosen method must provide the most reliable measure of an arm's length result<sup>29</sup> considering, primarily, the degree of comparability between the controlled transaction and any uncontrolled comparable, and the quality of the data and assumptions used in the analyses.<sup>30</sup> Degree of comparability, in turn, depends on the following factors: (1) functions, (2) contractual terms, (3) risks, (4) economic conditions, and (5) property or services.<sup>31</sup>

The first factor, functions, compares the functions performed and the resources utilized, considering: (1) research and development, (2) product design and engineering, (3) manufacturing production, and process engineering, (4) product fabrication, extraction, and assembly, (5) purchasing and materials management, (6) marketing and distribution functions, and (7)

27. INT'L MONEY FUND ET AL., A PLATFORM FOR COLLABORATION ON TAX 145 (2017), <http://www.oecd.org/tax/toolkit-on-comparability-and-mineral-pricing.pdf>.

28. OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 8.

29. 26 C.F.R. § 1.482-1(c)(1) (2017) ("The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result.").

30. *Id.* § 1.482-1(c)(2).

In determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method.

*Id.*

31. *Id.* § 1.482-1(d)(1)(i-v).

Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors). While a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Such factors include the following:

- (i) Functions;
- (ii) Contractual terms;
- (iii) Risks;
- (iv) Economic conditions; and
- (v) Property or services.

*Id.*

managerial services.<sup>32</sup> For example, an inappropriate comparison exists between one widget made entirely of gold, which took decades of research and development, and which is designed for a narrow industry, to another widget made of plastic, which took only one year to develop, and which is designed for fun because of the radically different functions and resources between the two widgets.

The second factor, contract terms, include: (1) form of the consideration, (2) volume, (3) scope and terms of the warranties, (4) rights to updates, revisions, and modifications, (5) duration, (6) collateral transactions between the buyer and the seller, and (7) extensions of credit and payment terms.<sup>33</sup> To illustrate, a contract that pays in cash, provides no warranties, and that lasts for the life of the entities is too dissimilar from a contract that pays in debt, provides a warranty for a certain number of years, and that only lasts for five years.

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32. *Id.* § 1.482-1(d)(3)(i)(A-H).

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction . . . . Functions that may need to be accounted for in determining the comparability of two transactions include[:]

- (A) Research and development;
- (B) Product design and engineering;
- (C) Manufacturing, production and process engineering;
- (D) Product fabrication, extraction, and assembly;
- (E) Purchasing and materials management;
- (F) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;
- (G) Transportation and warehousing; and
- (H) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

*Id.*

33. *Id.* § 1.482-1(d)(3)(ii)(A)(1-7).

Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These terms include:

- (1) The form of consideration charged or paid;
- (2) Sales or purchase volume;
- (3) The scope and terms of warranties provided;
- (4) Rights to updates, revisions or modifications;
- (5) The duration of relevant license, contract or other agreements, and termination or renegotiation rights;
- (6) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and
- (7) Extension of credit and payment terms. Thus, for example, if the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required even if no interest would be allocated or imputed under § 1.482-2(a) or other applicable provisions of the Internal Revenue Code or regulations.

*Id.*

The third factor, relevant comparability risks factors, include: (1) market risks, (2) risks associated with the success or failure of research and development activities, (3) financial risks, (4) credit and collection risks, (5) products liability risks, and (6) general business risks.<sup>34</sup>

The fourth factor, economic conditions, compares conditions that might affect the price charged, including: (1) the similarity of geographic markets, (2) the size and extent of the overall economic development in each market, (3) the market level, (4) the relevant market shares, (5) the cost of production and distribution, (6) the extent of competition in each market, (7) the economic condition of the particular industry, and (8) the alternatives realistically available to the buyer and seller.<sup>35</sup> For instance, it is useless to compare the crude oil market in Saudi Arabia, a country that limits crude oil exports, with the crude oil market in a country that does not place a cap on crude oil because of the dissimilar economic conditions.

34. *Id.* § 1.482-1(d)(3)(iii)(A)(1-6).

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include[.]

- (1) Market risks, including fluctuations in cost, demand, pricing, and inventory levels;
- (2) Risks associated with the success or failure of research and development activities;
- (3) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates;
- (4) Credit and collection risks;
- (5) Product liability risks; and
- (6) General business risks related to the ownership of property, plant, and equipment.

*Id.*

35. *Id.* § 1.482-1(d)(3)(iv)(A-H).

Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These factors include[.]

- (A) The similarity of geographic markets;
- (B) The relative size of each market, and the extent of the overall economic development in each market;
- (C) The level of the market (e.g., wholesale, retail, etc.);
- (D) The relevant market shares for the products, properties, or services transferred or provided;
- (E) The location-specific costs of the factors of production and distribution;
- (F) The extent of competition in each market with regard to the property or services under review;
- (G) The economic condition of the particular industry, including whether the market is in contraction or expansion; and
- (H) The alternatives realistically available to the buyer and seller.”).

*Id.*

Finally, the fifth factor, property and services, compares intangible property or services being transferred.<sup>36</sup> According to the Code of Federal Regulations, “[t]his comparison may include any intangible property that is embedded in tangible property or services being transferred (embedded intangibles).”<sup>37</sup>

### B. Price at an Arm's Length

To determine the second requirement, whether the price meets the arm's length standard, taxing authorities examine the method used. Both the IRS and the OECD employ five methodologies to determine if a multinational's transfer price for tangible assets satisfies the arm's length standard.<sup>38</sup> These methodologies include: (1) the comparable uncontrolled price (“CUP”) method, (2) the resale price method, (3) the cost plus method, (4) the transactional net margin method, and (5) the transactional profit split method.<sup>39</sup> While no single method is preferred or superior to the others, each applies most appropriately to particular situations. For example, “traditional transaction methods,” which include CUP, resale price, and cost plus methods, most directly establish whether a transaction was at arm's length.<sup>40</sup> This is because these methods easily trace prices back and can identify any

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36. *Id.* § 1.482-1(d)(3)(v) (“Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions.”).

37. *Id.*; see 26 C.F.R. § 1482-4(c)(2)(iii)(B)(1).

In order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangibles must (i) Be used in connection with similar products or processes within the same general industry or market; and (ii) Have similar profit potential.

26 C.F.R. § 1482-4(c)(2)(iii)(B)(1).

38. *Id.* § 1.482-1(a)(2).

In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).

*Id.*; OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 97.

39. OECD TRANSFER PRICING GUIDELINES, *supra* note 5 (“Traditional transaction methods are the comparable uncontrolled price method or CUP method, the resale price method, and the cost plus method. Transactional profit methods are the transactional net margin method and the transactional profit split method.”).

40. *Id.* at 98 (“Traditional transaction methods are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are arm's length.”).

difference between the uncontrolled versus the controlled transaction.<sup>41</sup> On the other hand, situations exist where the “transactional profit methods,” which include the transactional net margin method and the transactional profit split method, are the more appropriate methods.<sup>42</sup> This is particularly true where the transaction involves unique and valuable contributions or where the activities are integrated.<sup>43</sup>

These methods and their application are complex and warrant further explanation. First, the CUP method compares the price charged in the controlled transaction to the price charged in an uncontrolled transaction.<sup>44</sup> The degree of comparability is assessed under the same factors enumerated above.<sup>45</sup> The CUP method is particularly useful where the transactions are highly similar. According to the OECD, this method is the most direct, reliable, and preferred method where comparable uncontrolled transactions exist.<sup>46</sup> The CUP method is often rejected in practice, however, because the comparability criteria cannot match up, and, in certain industries, even a small comparability difference affects the price.<sup>47</sup> A different price results for the same tangible if, for example, that tangible is sold in two different markets, and a monopoly power exists in one market but not in the other. Consequently, the CUP method works best in “commodity-type markets” because the “homogenous nature” of the product and the equilibrium between supply and demand facilitate highly comparable circumstances.<sup>48</sup>

The resale price method focuses on the realized gross profit margin—that is, the difference between purchase price and selling price.<sup>49</sup> Under this

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41. *Id.* (“This is because any difference in the price of a controlled transaction from the price in a comparable uncontrolled transaction can normally be traced directly to the commercial and financial relations made or imposed between the enterprises, and the arm’s length conditions can be established by directly substituting the price in the comparable uncontrolled transaction for the price of the controlled transaction.”).

42. *Id.* (“There are situations where transactional profit methods are found to be more appropriate than traditional transaction methods.”).

43. *Id.* (“For example, cases where each of the parties makes unique and valuable contributions in relation to the controlled transaction, or where the parties engage in highly integrated activities, may make a transactional profit split more appropriate than a one-sided method.”).

44. 26 C.F.R. § 1.482-3(b)(1) (2017).

45. 26 C.F.R. § 1.482-3(b)(2)(i) (2017) (“Whether results derived from applications of this method are the most reliable measure of the arm’s length result must be determined using the factors described under the best method rule in § 1.482-1(c).”).

46. OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 101.

47. Elizabeth Hughes & Wendy Nicholls, *The Different Methods of TP: Pros and Cons*, TAX J. (Sept. 28, 2010), <https://www.taxjournal.com/articles/different-methods-tp-pros-and-cons>; *id.*

48. Hughes & Nicholls, *supra* note 47.

49. OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 105-06.

The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the ‘resale price margin’)

method, the arm's length price equals the resale price minus the gross profit margin, which is adjusted for the cost of acquiring the good.<sup>50</sup> The resale price method applies well to marketing operations, particularly between distributors and resellers.<sup>51</sup> Resale price is easiest to determine when the reseller does not substantially change the product in any way, thereby changing the value, and when the reseller realizes the profit in a short time frame.<sup>52</sup> This method allows broader product differences but still requires highly comparable functions.<sup>53</sup> For some tangibles, however, even small product differences can translate into substantial profit margin differences.<sup>54</sup> For example, the profit margin of a product that sells without much advertising is greater than the profit margin of a product that requires extensive marketing. The profit margin is smaller where the product requires extensive marketing to compensate for the cost of advertising.<sup>55</sup>

Under another method, the cost plus method first looks at the costs to the supplier or vendor and then adds a "cost plus mark-up" to arrive at an appropriate profit that considers the functions of the supplier or vendor and the market conditions.<sup>56</sup> The mark-up price should compare to that of an unrelated company if it had performed similar functions, with similar risks, and under similar market conditions.<sup>57</sup> The cost plus method performs well

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representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit.

*Id.*

50. *Id.* at 106 ("What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises.").

51. See Hughes & Nicholls, *supra* note 47.

52. *Id.*

53. OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 74 (stating that "[a]rm's length prices may vary across different markets even for transactions involving the same property or services; therefore, to achieve comparability requires that the markets in which the independent and associated enterprises operate do not have differences that have a material effect on price or that appropriate adjustments can be made").

54. Hughes & Nicholls, *supra* note 47.

55. *Id.*

56. OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 111 ("The cost plus method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to an associated purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction.").

57. *Id.*

in sales between manufacturers and related distributors.<sup>58</sup> This method is easy to implement, which is an advantage for many businesses.<sup>59</sup> However, its easy implementation is only in theory because the mark-up cost is difficult to determine through benchmarking analysis.<sup>60</sup> This is because companies account for cost at different stages and include different expenses.<sup>61</sup> For example, similar products can have different mark-ups if one company includes operating and overhead expenses in its mark-up but another company includes only overhead expenses.

The transactional net margin method, useful for services between related parties, such as back office management services and research and development, compares the net profit of a controlled transaction to the net profit of an uncontrolled transaction relative to an appropriate base.<sup>62</sup> The appropriate base could consist of sales, costs, or assets.<sup>63</sup> A major advantage of this method is the availability of public data regarding net profits of similar businesses in similar markets.<sup>64</sup> Nevertheless, whether the companies are truly comparable is questionable because the public data is insufficient.<sup>65</sup> Instead, companies must rely on the publicly available information and hope that it satisfies the tax authorities' comparability factors.

Finally, under the transactional profit split method, profit allocations relative to each party's contribution in a controlled transaction is compared to the profit allocation in an uncontrolled transaction between unrelated parties.<sup>66</sup> Each party's activities are weighted according to importance and the profits are split accordingly.<sup>67</sup> For instance, if a company contributes 80% to produce a tangible but its subsidiary contributes only 20%, the profit split should correspond to this percentage so that it reflects the different contributions. Though this method is simple in theory, it is difficult to implement because there are issues regarding the amount of profits to split and the concern that profit splitting incentivizes and spreads the cost of inefficiency.<sup>68</sup>

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58. *Id.* ("This method probably is most useful where semi finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.").

59. *Id.* at 111-12.

60. *Id.* at 112.

61. *Id.* at 112-15.

62. *Id.* at 117.

63. *See id.*; Hughes & Nicholls, *supra* note 47.

64. Hughes & Nicholls, *supra* note 47.

65. *Id.*

66. OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 133.

67. *See* Hughes & Nicholls, *supra* note 47.

68. *Id.*

*C. Lack of Data and Penalties for Non-Compliance*

The common thread running through all five pricing methods is their reliance on comparability: They depend on a high degree of comparability of uncontrolled transactions to controlled transactions to determine if a price is at arm's length. This determination requires a great amount of data. Unfortunately, both developed and developing countries currently lack the required public data and comparables.<sup>69</sup> Theoretically, various sources, such as commodity or financial exchanges, provide access to comparable data.<sup>70</sup> Most countries find relevant data through commercial databases, but the results remain limited because existing data is often incomplete or difficult to interpret.<sup>71</sup> In many circumstances, data is often difficult to access or even impossible due to privacy concerns.<sup>72</sup> Thus, publicly available data is sparse.

Although the lack of publicly available data affects the entire transfer pricing community, it particularly impacts developing countries.<sup>73</sup> Many reasons exist for this disparate impact. First, developing countries host fewer competing companies than developed countries.<sup>74</sup> Thus, comparable data is meager, if it exists at all. Second, developing countries typically lack the resources and manpower to compile, organize and review complete sets of data capable of accurate comparisons.<sup>75</sup> In addition, most databases focus on data from developed countries, which is not always relevant to markets in developing country markets, and even so, access is expensive.<sup>76</sup> Moreover, no data necessarily results from so called "first movers" in unexplored or under-exploited areas as no prior industry exists.<sup>77</sup>

Consequently, limited public data comparables fosters uncertainty regarding appropriate transfer pricing methods and does nothing to reduce the ever-looming threat of a tax audit. Even research into the best transfer pricing method offers multinationals little protection against audits. To illustrate, in 2013, Ernst and Young ("EY"), a global professional services firm, surveyed twenty-six countries regarding transfer pricing, including the

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69. See INT'L MONEY FUND ET AL., *supra* note 27, at 12.

70. *Id.* at 30 n.39.

71. *Id.* at 36.

72. See *id.* at 36 n.46.

73. *Id.* at 12.

74. *Id.* at 36, 37.

75. *Id.* at 159.

76. *Id.*

77. See *id.* at 16.

U.S.<sup>78</sup> The results indicated that 15% of companies litigated a transfer pricing case in the past year and 28% reported unresolved transfer pricing examinations, which is up from 17% in 2010 and 12% in 2007.<sup>79</sup> Additionally, interest charges stemming from transfer pricing adjustments affected 60% of the companies surveyed, 24% of which suffered penalties from an adjustment.<sup>80</sup> These numbers demonstrate that even companies in developed countries remain unsure about the arm's length standard and are not immune from penalties for implementing the standard incorrectly.

Furthermore, under that same survey, 47% of parent companies experienced double taxation after a transfer pricing adjustment.<sup>81</sup> Double taxation, a major area of concern in the transfer pricing community, occurs when different tax authorities impose liability on the same profits. While countries undoubtedly deserve their fair share of the taxes from profits in their jurisdiction, double taxation goes beyond making the deprived country whole and ultimately discourages global business activities.

In the U.S., the Internal Revenue Code assesses penalties when underpayment results from any number of reasons under the Code.<sup>82</sup> In general, the penalty equals 20% of the underpaid tax when: (1) the transfer price is either 200% more, or 50% less than the arm's length price; or (2) where the adjustment exceeds gross receipts by \$5 million or 10%, whichever is lower.<sup>83</sup> For example, if the correct transfer price is \$100, then the penalty is 20% where the actual transfer price was more than \$200 or less than \$50. The penalty spikes to 40% when: (1) the transfer price is either 400% more, or 25% less than the arm's length price; or (2) where the adjustment exceeds gross receipts of \$20 million or 20%, whichever is less.<sup>84</sup> Thus, just like the previous example, a 40% penalty is assessed if the price is more than \$400 or less than \$25. In reality, however, the penalties are far more. In the case of Apple, for instance, 40% of \$40 billion is a hefty fine.<sup>85</sup> One saving-grace of the penalty section is that the penalties max out at 40%, though that might not offer entities like Apple much comfort.<sup>86</sup> No penalty attaches at all,

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78. ERNST & YOUNG, NAVIGATING THE CHOPPY WATERS OF INTERNATIONAL TAX 3, 57 (2013), [https://www.ey.com/Publication/vwLUAssets/EY-2013\\_Global\\_Transfer\\_Pricing\\_Survey/\\$FILE/EY-2013-GTP-Survey.pdf](https://www.ey.com/Publication/vwLUAssets/EY-2013_Global_Transfer_Pricing_Survey/$FILE/EY-2013-GTP-Survey.pdf).

79. *Id.* at 24.

80. *Id.* at 4, 7, 24.

81. *Id.* at 24.

82. 26 C.F.R. § 1.6662-5(a) (2017).

83. 26 C.F.R. § 1.6662-6(b) (2017).

84. 26 C.F.R. § 1.6662-5(g) (2017); *id.* § 1.6662-6(a), (b)(2), (c) (2017).

85. Apple faced \$16 million in IRS penalties. *See* 26 C.F.R. § 1.6662-5 (2017).

86. *See generally* 26 C.F.R. § 1.6662-5 (2017); 26 C.F.R. § 1.6662-6 (2017).

however, if the taxpayer can show reasonable cause for the underpayment and that the taxpayer acted in good faith.<sup>87</sup>

### III. DISCLOSING APAS WOULD BENEFIT THE TRANSFER PRICING COMMUNITY

An alternative to the traditional transfer pricing methodologies is to execute an APA. APAs are negotiated agreements that, from the start, determine the applicable transfer pricing method for certain transactions over a fixed period of time.<sup>88</sup> These agreements can be unilateral, bilateral, or multilateral.<sup>89</sup> Unilateral agreements occur between the company and the tax authority where the company is located.<sup>90</sup> Bilateral and multilateral agreements are between the company and several tax authorities (because the related company could sit in different tax jurisdictions).<sup>91</sup> In most cases, companies prefer bilateral or multilateral agreements because these offer a reduced risk of double taxation, are fair to all parties (multinational and taxing authorities in all relevant jurisdictions), and provide greater certainty to the tax-paying multinational.<sup>92</sup>

To negotiate an APA in the U.S., the IRS requires specific information, such as the agreed transfer pricing method, the relationship of the companies involved, the transactions covered, and the number of years the APA is effective.<sup>93</sup> Most importantly, the IRS mandates that the APA contain “critical assumptions” regarding future events.<sup>94</sup> Critical assumptions are “fact[s] whose continued existence [are] identified in an APA as being material to the reliability of the APA’s covered methods.”<sup>95</sup> These facts can relate to the company, a third party, an industry, or business and economic regulations.<sup>96</sup> If the APA fails to include one or more critical assumptions,

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87. 26 C.F.R. § 1.6662-5(a) (2017). The good faith exception applies to penalties only; it is not an exception to the disclosure provisions. *Id.* See 26 C.F.R. § 1.6664-4(f) (2017) for the rules relating to the good faith exception.

88. See OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 214.

89. DELOITTE, ADVANCE PRICING AGREEMENT FREQUENTLY ASKED QUESTIONS 3 (2012), <https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/thoughtpapers/in-tax-deloitte-apa-faqs-noexp.pdf>.

90. *Id.*

91. *Id.*

92. See OECD TRANSFER PRICING GUIDELINES, *supra* note 5, at 216.

93. *Id.* at 216-17.

94. *Id.* at 215.

95. Rev. Proc. 2015-41, 2015-35 I.R.B. 263.

96. *Id.*

the IRS is authorized to revise or even revoke the agreement.<sup>97</sup> Thus, critical assumptions of future events are crucial and at the heart of an APA.<sup>98</sup>

Currently, the Internal Revenue Code prohibits disclosure of APAs in the U.S. because APAs qualify as confidential return information under section 6103 rather than written determinations under section 6110.<sup>99</sup> These provisions came about following a 1996 lawsuit in which the Bureau of National Affairs attempted to force the IRS to disclose APAs under section 6110 and the Freedom of Information Act.<sup>100</sup> After a long battle, the IRS conceded that APAs were written determinations, but Congress quickly recategorized the agreements as confidential return information, thereby prohibiting disclosure.<sup>101</sup>

Essentially, business leaders and industry representatives lobbied Congress to ensure these documents would not become public information.<sup>102</sup> To appease disclosure proponents, however, Congress also passed the Tax Relief Extension Act requiring that the Treasury Department publish annual APA reports.<sup>103</sup> The Act mandated that each report contain certain information, such as model APAs, statistics regarding requests and applications, and general information regarding transfer pricing schemes.<sup>104</sup> In other words, the annual reports contained only generalized information rather than facts and numbers that could serve as useful comparisons.

Considering the EY litigation statistics, the financial burden that audits impose on both parties, and the potentially steep readjustment penalties, the IRS should publicly disclose APAs in their entirety.<sup>105</sup> Disclosure would provide clarity and generally increase public confidence in government standards.

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97. *Id.*

98. *Id.*

99. See I.R.C. §§ 6103(2)(c), 6110; Rev. Proc. 2015-41, 2015-35 I.R.B. 263.

100. Bureau of Nat. Affairs, Inc. v. IRS, 24 F. Supp. 2d 90, 94 (D.D.C. 1998).

101. See Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 521, 113 Stat. 1862, 1925-27 (2000); John L. Abramic, Note, *Advance Pricing Agreements: Confidential Return Information or Written Determinations Subject to Release*, 76 CHI.-KENT L. REV. 1823, 1824 (2001) (citing Pub. L. No. 106-170, § 521, 113 Stat. at 1925-27).

102. Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 521, 113 Stat. at 1925-27; Abramic, *supra* note 101, at 1842 (first citing Barton Massey, *Shielding APAs: Was There Fair Debate of Policy Concerns?*, 19 TAX NOTES INT'L 2389, 2389-90 (1999); and then citing Pub. L. No. 106-170, § 521, 113 Stat. 1925-27).

103. Tax Relief Extension Act of 1999, Pub. L. No. 106-170, § 521, 113 Stat. at 1925-27; Abramic, *supra* note 101, at 1842 (citing Pub. L. No. 106-170, § 521, 113 Stat. 1925-27).

104. Tax Relief Extension Act § 521, 113 Stat. at 1925-27; Abramic, *supra* note 101, at 1842-43 (citing Pub. L. No. 106-170, § 521, 113 Stat. 1925-27).

105. See *supra* section II for discussion on litigation, audits, and penalties.

First, disclosure creates transparency and uniformity regarding the arm's length standard because APAs require specificity and detail. Executed APAs provide a good starting point for comparisons to other multinationals, depending on the APA and the agreement type, the applicable industry, and the covered transactions. APA disclosure is analogous to judicial precedent, which is important in the legal context because precedents provide for consistent rulings and clear standards. Here, disclosing APAs would serve the same purpose: It would provide taxpayers with clear standards of acceptable and unacceptable conduct in certain situations from the IRS itself. This tax-precedent at least offers multinationals the opportunity to avoid adjustments and costly penalties from taxing authorities.

In addition, because the number of executed APAs is relatively small compared to the number of received APAs, these agreements will be easy to categorize. Out of the 2,245 APAs the IRS has received from 1991 through 2016, only 1,597 have been executed.<sup>106</sup> An APA database could organize the data by agreement type, industry or transaction, and then include searchable terms, or "headnotes," like those found in legal databases like LexisNexis or Westlaw. Organizing these agreements by industry would ensure that the APAs are easily accessible for companies that would like to utilize them. Like any other database, the owner may require a fee to access the database, a portion of which would cover expenses involved in maintaining and updating the records. If Westlaw can organize and update hundreds of thousands of legal documents each day, the IRS or a private company can easily organize the 1,597 APAs in existence today and incorporate the few new agreements the IRS enters into each year.

Finally, disclosure would level the playing field for smaller multinationals that lack the resources to execute an APA themselves. Just as not every company can afford to conduct a costly transfer pricing study, not every multinational can afford to enter into an APA with the IRS and/or other taxing authorities. To explain, the fee to apply for an APA with the IRS is \$60,000, and the renewal fee is \$35,000 for each renewal request.<sup>107</sup> Thus, smaller multinationals that do not compete on the same economic playing-field as conglomerates like HSBC or Exxon would particularly benefit from being able to access other APAs at little or even no cost. This would allow

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106. I.R.S. Announcement 2017-03, 2017-15 I.R.B. 1077, <https://www.irs.gov/pub/irs-irbs/irb17-15.pdf>.

107. See Rev. Proc. 2015-41, 2015-35 I.R.B. 263. The renewal fee is still \$35,000 even if the renewal makes no changes. In addition, each amendment to a current APA costs \$12,500 per amendment. *Id.*

them to use these executed APAs as models and then adjust their own agreement accordingly.

Second, disclosure promotes public confidence by allowing the public to act as a second “check” on government and corporate standards. It is not hard to imagine that, without public scrutiny, tax authorities could give better deals to one company but not another. Transparency through disclosure deters this behavior and incentivizes taxing authorities to act with fairness and consistency. The public could check these APAs to ensure that the deals are fair, and any discrepancy they have will have to be addressed by the IRS. In addition, public disclosure strongly encourages the IRS to look at not only the present impact of the APAs, but the long-term effects of their agreements as well. That is, the IRS would need to consider how other people and other companies will react to a particular deal, and how other companies will use the data as a comparison for their own dealings with the IRS.

In a similar fashion, disclosure gives multinationals some leverage in dealings with taxing authorities, thereby lessening the company’s tax liability in a given jurisdiction. For example, in 2006, the Securities and Exchange Commission (“SEC”) adopted a rule that required publicly held companies to disclose compensation of their chief officers and other high-ranking members.<sup>108</sup> This decision was partly due to widespread disparities between consumer and worker wages, and executive compensation. The SEC hoped the legislation would help equalize wages.<sup>109</sup> While, several surveys report that some executive compensation actually increased since the SEC rule, executive compensation is lower when taken as a whole.<sup>110</sup> One possible explanation for this is that executives who were paid less in the past have now demanded more compensation after seeing what their counterparts received.<sup>111</sup>

This unintended consequence could also arise in the APA disclosure context. If multinationals can assess other deals, for example, the increased “competition” could in turn drive tax liability down. Much like how competition drives down market prices, here, competition may allow companies to force the IRS to cut better deals by demanding the same price as a competitor. This bargaining chip is important because it would allow companies more control over how much tax they pay, even if that control is minimal. Even so, this “competition” has a bright side: While each entity

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108. *Fast Answers: Executive Compensation*, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/fast-answers/answers-execomphm.html> (last updated Oct. 21, 2014).

109. *Id.*

110. *See, e.g.*, Alexandre Mas, *Does Transparency Lead to Pay Compensation?*, 125 J. POL. ECON. 1683 (2017).

111. *See id.*

may owe less individually, it will be more difficult for a company to avoid paying taxes altogether.

Moreover, audits are costly both to the taxing authority and the multinational being audited.<sup>112</sup> In 2014, for example, Microsoft initiated litigation against the IRS under the Freedom of Information Act because the IRS hired an outside law firm, Quinn Emanuel Urquhart & Sullivan, to pursue Microsoft in a tax audit.<sup>113</sup> The IRS agreed to pay the firm \$2.2 million to assist in its Microsoft investigation in connection with a cost sharing agreement<sup>114</sup> between Microsoft and its overseas subsidiary.<sup>115</sup> Critics perceived this tactic as the IRS's lack of confidence in its ability to carry out an audit on its own.<sup>116</sup> Others saw the move as a "willingness to vigorously litigate transfer pricing, even in the face of a number of significant past losses."<sup>117</sup>

In a similar situation, Amazon prevailed in a \$1.5 billion transfer pricing dispute with the IRS.<sup>118</sup> At issue here was Amazon's transfer of its intangible assets to its Luxembourg subsidiary at prices the IRS determined were suspiciously low.<sup>119</sup> The subsidiary agreed to pay Amazon \$254.5 million worth of buy-in payments over seven years. But, according to the IRS's calculations, the payments should have totaled \$3.5 billion.<sup>120</sup> The IRS also estimated that Amazon maintained almost \$235 million in prior tax deficiencies.<sup>121</sup> In the end, the U.S. Tax Court sided with Amazon, condemning the IRS's behavior as an abuse of power.<sup>122</sup> In the *Amazon* case, IRS critics claimed that the litigation was simply the IRS rehashing a different transfer pricing case it lost in 2005.<sup>123</sup> In fact, despite the decade

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112. Vidya Kauri, *IRS Must Rethink Transfer Pricing Cases After Amazon Loss*, LAW360 (Mar. 24, 2017, 10:20 PM).

113. *United States v. Microsoft Corp.*, 154 F. Supp. 3d 1134, 1141-42 (W.D. Wash. 2015); see Forst & Neumann, *supra* note 1.

114. According to the Code of Federal Regulations § 1.482-7A, a CSA is "an agreement under which the parties agree to share the cost of development of one or more intangibles in proportion to their shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement." 26 C.F.R. § 1.482-7A (2017).

115. See Forst & Neumann, *supra* note 1.

116. *Id.*

117. *Id.*

118. *Amazon.com, Inc. v. Comm'r*, 148 T.C. 8 (2017); Martin, *supra* note 2.

119. *Amazon.com, Inc.*, 148 T.C. at 5.; Martin, *supra* note 2.

120. *Amazon.com, Inc.*, 148 T.C. at 6.; Martin, *supra* note 2.

121. Martin, *supra* note 2.

122. *Amazon.com, Inc.*, 148 T.C. at 177.

123. In *Xilinx v. Commissioner of Internal Revenue*, the parent company had a CSA to develop intangibles with its foreign subsidiary. Each party paid a percentage of the total research and development costs based on how much they were going to receive in benefits from the intangibles.

between the *Xilinx* and *Amazon* cases, the IRS put forth very similar arguments.<sup>124</sup> Here, disclosing APAs would save resources on both sides by reducing the number of tax disputes and litigation between the IRS and multinationals. Not only would the IRS save taxpayers money by not relitigating the same issues, multinationals would save money by not defending against these suits.

Third, disclosure promotes international cooperation. The U.S. is one of the most influential countries in the world, with an economy to match.<sup>125</sup> Its economy is the largest in the world, at about \$19 trillion in gross domestic product, making up about 25% of the gross world product.<sup>126</sup> In 2017, the U.S. corporate tax rate dropped from 35% to 21%.<sup>127</sup> While the U.S. held one of the steepest corporate tax rates for many years, tax reforms brought it closer to the world average, which is approximately 23.5%.<sup>128</sup> The assumption is, now that the U.S. is more “tax neutral” (that is, its corporate tax rate falls close to the world average), it has no incentive to side with any particular tax jurisdiction, whether a high or low tax jurisdiction. Other tax jurisdictions will see the U.S.’s actions as unbiased because it is a middle-of-the-road jurisdiction. In turn, other U.S. actions would carry more weight since a neutral stance usually does not carry suspicious motives as well.

Similarly, if the U.S. chose to change its policies on APA disclosures, other countries may also be incentivized to follow suit. Any country that chooses not to follow the U.S.’s lead in APA disclosure risks alienating itself from the U.S. economic circle. Multinationals may also hesitate to conduct business with these outliers for fear that the outlier might be an economic outsider. To maintain a competitive edge in the transfer pricing field, then, other countries would be wise to follow the U.S.’s lead. More holistically, though, international cooperation in APA sharing would bring a more unified, consistent approach to the international transfer pricing community.

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The parent then issued stock options to its employees performing research and development but did not include in research and development costs any amount related to the issuance of stock options to, or exercise of stock options by, its employees. The IRS argued that it should have been included. In the end, the tax court ruled against the IRS. *Xilinx v. Comm’r*, 125 T.C. 37 (2005); see 26 C.F.R. § 1.482-7A (2017).

124. See Kauri, *supra* note 112.

125. Devon Haynie, *These Are the Top 5 Most Influential Countries*, U.S. NEWS (Jan. 23, 2018, 12:01 AM), <https://www.usnews.com/news/best-countries/best-international-influence>.

126. Prableen Bajpai, *The World’s Top 20 Economies*, INVESTOPEDIA (Aug. 16, 2018, 11:06 AM), <https://www.investopedia.com/articles/investing/022415/worlds-top-10-economies.asp>.

127. Kyle Pomerleau, *The United States’ Corporate Income Tax Rate is Now More in Line with Those Levied by Other Major Nations*, TAX FOUND. (Feb. 12, 2018), <https://taxfoundation.org/us-corporate-income-tax-more-competitive/>.

128. *Id.*

This consistency allows multinationals to better predict the range of possible outcome of their transactions, thus bringing more peace of mind.

Furthermore, a unified approach would lessen the stress multinational entities experience in attempting compliance with the arm's length standard. For example, some multinationals take a head-in-the-sand approach, whereby they do nothing at all and hope for the best.<sup>129</sup> The rationale is that, while they do not understand the tax rules of transfer pricing, neither does the IRS (which could explain the increase in litigation yet major IRS loses).<sup>130</sup> These companies hope to skate by under the radar and appease the IRS by doing the bare minimum. On the other hand, some companies fully dive into the complex world that is transfer pricing and implement a "full blown" comprehensive approach.<sup>131</sup> These companies build transfer pricing teams that consist of accountants, attorneys, computer programmers, economists, engineers, financial analysts and many other specialists to make sure they are complying with the rules.<sup>132</sup> One can imagine how costly building such a team can be. A more unified approach could alleviate some of this financial stress, or at least would allow the resources to shift and be put to a better use. Such an approach would also reward professionalism, since the accounting professionals will be able to offer more precise advice.

#### IV. SOLVING THE ISSUE OF PROPRIETARY INFORMATION AND TRADE SECRETS

Although opponents of disclosure argue that APAs contain confidential information such as trade secrets and proprietary information, all of this can be redacted before the APAs are published. Disclosing APAs is similar to the Private Letter Rulings that the IRS already publishes. Private letter rulings are "written statement[s] issued to a taxpayer that interpret[] and appl[y] tax laws to the taxpayer's represented set of facts."<sup>133</sup> It is written in response to a written request by the taxpayer.<sup>134</sup> Private Letter Rulings are important because they provide other taxpayers with information and general

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129. Robert Feinschreiber, *Practical Aspects of Transfer Pricing*, 70 FLA. B.J. 41 (1996).

130. *Id.*

131. *Id.*

132. *Id.*

133. *Tax Exempt Private Bonds Private Letter Rulings: Some Basic Concepts*, INTERNAL REVENUE SERV., <https://www.irs.gov/tax-exempt-bonds/teb-private-letter-ruling-some-basic-concepts> (last updated Apr. 20, 2018).

134. *Id.*; see *Understanding IRS Guidance: A Brief Primer*, INTERNAL REVENUE SERV., <https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer> (last updated May 9, 2018).

knowledge on what the IRS is likely to do in a given situation. They provide much-needed guidance for the average citizen to comply with the complex tax codes. Here, APAs follow the same general concept of a Private Letter Ruling in that they are also requested by the taxpayer and are specific to a set of facts or circumstances. If the IRS is able to publish Private Letter Rulings where the facts have been slightly changed to protect the identity of the taxpayer, they should also publish redacted APAs.

One can understand the taxpayer's concern when it comes to proprietary information or trade secrets. For companies like Coca-Cola where the brand itself is built on a secret formula, one can understand the hesitation of entering into an APA, since it might mean exposing trade secrets.<sup>135</sup> Yet, for less extreme situations, such as when a company does not want to publicize its profit margins, the public good outweighs the company's desire to keep certain numbers a secret. Sometimes, certain details will have to be disclosed and cannot be redacted, whether companies like it or not.

As it currently stands, however, both sides stand to lose too much in resources when it comes to litigating transfer pricing disputes. If the IRS could spend \$2.2 million to hire Quinn Emmanuel to chase down one multinational, then this is an area that could benefit from standardization. That is only one instance. The IRS has gone after many other large multinationals, such as Amazon and Microsoft.<sup>136</sup> One can only imagine how much time and resources the IRS has spent in chasing down companies and auditing them in the hopes of finding some sort of tax avoidance scheme. The IRS would need to strike a balance between redacting certain information and disclosing certain information, because admittedly, if APAs are redacted too much, they would become useless.

One similar parallel that can be drawn is when parties in litigation redact sensitive documents to hand over in discovery. Under Federal Rule of Civil Procedure 26, the party "from whom discovery is sought may move for a protective order," and "[t]he court may, for good cause, issue an order to protect a party or person from annoyance, embarrassment, oppression, or undue burden or expense."<sup>137</sup> This rule also specifies that the court may require "a trade secret or other confidential research, development, or

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135. Coca-Cola generally maintains that its formulas are "among the important trade secrets of [the] Company." Coca-Cola Co., Annual Report (Form 10-K) (Feb. 25, 2015). In an ongoing tax dispute with the IRS, in which Coca-Cola contested the IRS's \$3.3 billion tax assessment, the company successfully sought a protective order preventing the IRS from disclosing its trade secrets. *See Coca-Cola Co. v. Comm'r*, No. 311830-15 (T.C. Nov. 22, 2017); *Coca-Cola Co. v. Comm'r*, 149 T.C. 21 (2017).

136. *See Amazon.com, Inc. v. Comm'r*, 148 T.C. 8 (2017); *United States v. Microsoft Corp.*, 154 F. Supp. 3d 1134, 1141-42 (W.D. Wash. 2015); Forst & Neumann, *supra* note 1.

137. Fed. R. Civ. P. 26(c)(1).

commercial information not be revealed or be revealed only in a specified way.”<sup>138</sup>

Similarly, when companies resist divulging certain information, the IRS should be allowed to exercise judgment when it comes to disclosing that information. There must be a balance between redaction and disclosure. The IRS would be in a good position to decide what is important information that should not be disclosed, and what is not important information that would be harmless if disclosed. The case could be that the parties who fear their trade secrets will be exposed are being too cynical or looking at the information too narrowly. As an outsider, the IRS will have an unbiased view of what is and is not important. It has the experience and expertise to do so, since it will have seen and executed many APAs.

Furthermore, redaction is used in many different areas of the law with high levels of success. In the era of technology and the internet, more and more paperwork is filed online and oftentimes, these filings contain confidential information. Courts and lawyers have been able to redact sensitive information from these filings without mishaps. Another example illustrating the innocuous nature of disclosure is the SEC's required disclosures for public companies.<sup>139</sup> For companies to qualify as public, they must be traded on a national stock market or have an investor base that is a certain size.<sup>140</sup> Under the SEC 1934 Act, public companies are required to file annual 10-K reports, quarterly 10-Q reports, form 8-K, proxy statements, and reports related to things such as mergers, acquisitions, tender offers, and securities transactions by company insiders, just to name a few requirements.<sup>141</sup>

Within the 10-K report is information regarding the company's operations, risks the company currently faces, its accounting policies and practices, and executive compensation.<sup>142</sup> But that is not all. Most importantly, the 10-K contains financial statements that shows how much money the company made and how much debt it has, among other important financial information.<sup>143</sup> These statements include income statements and balance sheets, which allows the reader to peek into the company's

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138. *Id.*

139. *Public Companies*, U.S. SEC. & EXCH. COMM'N, <https://www.investor.gov/introduction-investing/basics/how-market-works/public-companies>.

140. *Id.*

141. 15 U.S.C. § 78d (2012); *id.*

142. *How to Read a 10-K*, U.S. SEC. & EXCH. COMM'N (Sept. 7, 2011), <https://www.investor.gov/news-alerts/investor-bulletins/how-read-10-k>.

143. *Id.*

finances.<sup>144</sup> One can imagine how important financial data is, especially when it comes to how much money a company makes and its debt levels.

Considering how much information is required to be disclosed under the 1934 Act, and how all public companies have complied, the take away from this should be that there is no harm in disclosure. So much has already been disclosed, and continues to be disclosed, yet, no great harm has come to these companies like the opponents of disclosure would have one believe. Taxpayers should also look at disclosure in a positive light. These SEC disclosures arm investors with the right information to make their investment choice. Similarly, disclosure of APAs would arm taxpayers with the right information so that they are better informed when it comes time to negotiate with tax authorities.

Currently, although the IRS does publish an annual report on APAs, the information contained in that document is a general overview of the program and the different sectors or industries. This is insufficient given the nature of the complexity of transfer pricing itself, which needs specific numbers and more information. Taxpayers need to be able to look towards concrete facts and numbers to use as their base. Moreover, transfer pricing depends on comparability, which would not work well with only generalized information. Redacting proprietary information in APAs would serve better as comparables instead of generalized information.

## V. CONCLUSION

In an era of globalization, where sixty percent of international trade occurs within, and not between, multinationals,<sup>145</sup> it is crucial that companies are treated fairly regarding the amount of tax they pay. This requires striking a balance between implementing fair and manageable deals, while at the same time ensuring that tax authorities receive the taxes they are owed. This delicate balance is especially difficult to realize when so much confusion exists as to what the arm's length standard entails. The IRS must look to publishing APAs to solve this issue. Doing so would facilitate the balance through heightened clarity standards for legal compliance, public and taxpayer confidence, and international cooperation. After all, according to Justice Brandeis, sunlight is the best disinfectant.

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144. *Id.*

145. See OECD TRANSFER PRICING GUIDELINES, *supra* note 5.