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Transfer Pricing: Current Problems and Solutions

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CHAPTER 1-INTRODUCTION

The current transfer pricing problems in the United States have materialized into statistics that are difficult to wrap our heads around. Pfizer Inc. between the years of 2007 and 2009 reported a net loss of $5.2 billion in the United States, the country where its corporate headquarters is located. In those same years, its foreign subsidiary located in Ireland, reported a pretax profit of $20.4 billion.[1] Oracle Corporation's Irish subsidiary paid no income taxes in 2006 and 2007 while it managed to produce one fourth of Oracles' total pretax income. The subsidiary located in Ireland accomplished all of this without one recorded employee.[2] Thousands of other multinational corporations are taking advantage of the transfer pricing regulations and creating enforcement and financial problems for our government.

The frequency of transfer pricing tax evasion by corporations now challenges the enforcement of United States and International Tax Laws. Recent reports and news articles have covered how multinational corporations are abusing loopholes in the current international tax system. Companies like Pfizer Inc., Oracle Corp, Google Inc, and thousands of other American based companies are engaging in legal transfer pricing activities by shifting assets to foreign-base subsidiaries to avoid paying United States taxes. This has raised financial red flags for the United States Government, as an estimated $60 billion are being evaded each year.[3] With high profiting large multinational corporations ducking out of paying these taxes, more burden is

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[1] Drucker, Jessie, "Tax `Shenanigans' Turn U.S. Sales to Foreign Income With Billions Offshore," *Bloomberg,* July 22, 2010 Accessed October 24,2010 http://www.bloomberg.com/news/2010-07-23/tax-shenanigans-turn-u-s-sales-to-foreign-income-with-billions-offshore.html.

[2] Drucker, Jessie

[3] Long, Melissa, "Google Uses Loopholes to Cut Taxes by $3.1 Billion" (Video) October 21, 2010. http://www.bloomberg.com/video/63898300/

being shifted to the small companies and the citizens of this country to pay for national security, school systems and public services.[4]

The IRS has taken steps to realign certain internal divisions in order to create a more centralized organization dedicated to improving and monitoring international tax compliance. The realignment announced on August 4, 2010 has been implemented as of October 1, 2010 and will focus on offshore tax evasion.[5] This is to be accomplished by "coordinating the competent authority more closely with field staff that originate[s] cases, especially those dealing with transfer pricing and enhancing the IRS's focus on transfer pricing."[6] This restructuration of focus also included revising tax treaties and tax information exchange agreements to increase the difficulty of internationally evading taxes.[7]

CHAPTER 2- THE CURRENT SITUATION

Transfer pricing is defined as the price charged between related parties for goods, services, or use of property.[8] Transfer pricing is globally used by a large amount of companies and related enterprises to replicate cost allocations. It is a significant part for both the tax payers

[4] Levin, Sander M., "Hearing on Transfer Pricing Issues," Hearing before the Committee on Ways and Means. U.S. House of Representatives, One hundred Eleventh Congress, Second Session, July 22, 2010. http://waysandmeans.house.gov/Hearings/transcript.aspx?NewsID=11273

[5] "IRS Realigns and Renames Large Business Division, Enhances Focus on International Tax Administration," IRS Newswire, August 4, 2010. http://www.irs.gov/newsroom/article/0,,id=226284,00.html

[6] IRS Newswire

[7] IRS Newswire

[8] "Transfer Pricing" *BusinessDictionary.com*, November 18, 2010 http://www.businessdictionary.com/definition/transfer-price.html

and tax administrators because cost allocations have a large impact on income, which ultimately determines a corporation's taxable income.[9]

One of the current issues the IRS is dealing with, involves legally shifting profits out of the U.S. to tax havens like Bermuda, Switzerland, Ireland, Singapore, and the Cayman Islands.[10] These nations have lower corporate tax rates compared to the United States' 35 percent. Some even have special tax exemptions for operating businesses in their country which pose large financial benefits for U.S. based companies. By taking advantage of these foreign tax rates and exemptions, multinational corporations are lowering their international tax rates and reporting higher profits.[11]

The general process that these worldwide companies employ is similar to the following example:

A corporation is comprised of a United States parent company, a foreign principal and other foreign subsidiaries. The foreign subsidiaries' purpose is to distribute and/or manufacture products while the foreign principal holds the responsibility of making executive and investment business decisions.[12] In addition, the foreign principal holds the intangible property which is the trademark, patent or property the business profits on. The U.S. parent company supplies marketing knowledge, supporting services and sometimes engages in domestic and foreign distribution. The foreign subsidiaries and the U.S parent company run limited risk operations

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[9] Transfer Pricing" *BusinessDictionary.com.*

[10] Sullivan, Martin, "Hearing on Transfer Pricing Issues," Hearing before the Committee on Ways and Means. U.S. House of Representatives, One hundred Eleventh Congress, Second Session, July 22, 2010. http://waysandmeans.house.gov/Hearings/transcript.aspx?NewsID=11273

[11] Sullivan, Martin

[12] Barthold, Tom "Hearing on Transfer Pricing Issues" July 22, 2010.

which are considered low profit in transfer pricing analysis, while the high profit activities occur at the foreign principal because it holds the intangible property. [13] Therefore, the corporation will allocate or transfer a majority of their income to the foreign principal located in a country with a tax exemption or low tax rates. Overall, this process leads to lower overall taxes and increased returns for the corporation's investors.[14]

The controversy of this method is that the intangible property the foreign principal owns was developed in the United States but taxed in another country. Intangible property, as the name suggests, lacks any physical form and therefore the only incentive for ownership in one country as opposed to another is tax avoidance.[15] Frequently, the intangible property is developed using American technology and research, both of which are subsidized by United States tax incentives. Just before the product, containing the intangible property, is produced or released, it is transferred to a foreign principal located in a tax haven. While corporations boast higher profits and lower taxes, the U.S. Treasury is left with little return on their investments.[16]

Intangible property can be shifted to foreign principals with a cost sharing or licensing agreement. In a cost sharing agreement, a United States parent and a foreign principal will agree upon how costs for developing intangible property are to be allocated between them. With this agreement, if a patent was produced by the parent, the foreign principal has the rights to use that patent for a portion of developmental costs.[17] There are tax incentives because if the parent is

[13] Barthold, Tom
[14] Barthold, Tom
[15] Levin, Sander M. "Hearing on Transfer Pricing Issues" July 22, 2010.
[16] Levin, Sander M.
[17] Barthold, Tom

located in a higher tax jurisdiction than the principal and the developmental costs are less than market-based royalty fees, the corporation can decrease its global tax liability.[18]

When the IRS approved and adopted the cost sharing method for transfer pricing, it was done for two reasons. The first was to avoid the need to value a firm's intangible property. The costs in creating the intangible property would already be shared by the two parties, thus both are part owners. [19] Yet parent companies under cost sharing agreements are still selling and transferring intangible property to their subsidiaries. The second reason for implementing cost sharing was to distribute equally the high-risk of research and development. Research and development and other intangible property advancements are considered high-risk and the agreement allows the risk to be spread among parent companies and their subsidiaries. Nonetheless, corporations are shifting cost and risks under transactions that appear to violate the arm's length standard. [20]

A licensing agreement between a U.S. parent and its foreign principal contains terms for preexisting intangible property rights and royalty payments in return. These royalty payments are taxable income in the United States.[21] The current issue surrounding the sale and transfer of intangible property is how to accurately value the transaction. Without an accurate value, an appropriate arm's length payment or royalty fees are difficult to support.[22]

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[18] Dye, Ronald A., "Cost-Sharing Agreement A tax-saving device of multi-nationals,""Valuation Issues for Buy-In Payments Associated with Cost-Sharing Agreements" Kellogg School of Management, 2008. http://insight.kellogg.northwestern.edu/index.php/Kellogg/article/cost_sharing_agreements

[19] Morgan, William R. "Hearing on Transfer Pricing Issues" July 22, 2010.

[20] Morgan, William R.

[21] Barthold, Tom

[22] Barthold, Tom

The use of the arm's length standard in U.S. transfer pricing regulations is another major problem and may be the root of all transfer pricing issues. All transfer pricing disputes arise over the arm's length standard principal. In court, corporations will support related party transfer prices and allocations with unrelated transactions, believed to be within arm's length. The IRS will argue that the unrelated transaction is not arm's length because of a difference in quantity, market price, type of customer, packaging and other non-monetary factors. But because certain transactions are unique and no comparable unrelated transaction exists, a level of ambiguity surrounds the arm's length standard. Especially with transactions concerning intangible property, no comparables exist because of their nature.[23]

If the arm's length standard is ruled violated by the Tax Court, Section 482 of the IRS Tax Code- Allocation of Income and Deductions among Taxpayers, "authorizes the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent evasion of taxes or to clearly reflect their income."[24] Its main purpose is to deter and prevent related taxpayers from shifting income between each other by placing related taxpayers and the same level as unrelated taxpayers.

CHAPTER 3- SHIFTING INTANGIBLE PROPERTY

Google has legally evaded $3.1 billion dollars worth of taxes in the past three years through a process Google and many other global corporations have utilized called "Double Irish"

[23] Avi-Yonah,Reuven, "Hearing on Transfer Pricing Issues" July 22, 2010.

[24] "Transfer Pricing," IRS Business, October 14, 2010 http://www.irs.gov/businesses/international/article/0,,id=120220,00.html

or “Dutch Sandwich.”[25] These companies have shifted income through multiple foreign subsidiaries and tax havens in order to take advantage of lower tax rates. Google has dropped its foreign tax rate to a shocking 2.4 percent; while within the United States, they are paying the 35 percent corporate tax rate.[26] Google moves its profits through Ireland, the Netherlands and Bermuda, every stop taking advantage of each country’s corporate tax laws.

Google’s subsidiary, Google Ireland Limited, located in Dublin, sells advertising and transfers its profits by paying royalty fees to Google Ireland Holdings. Google Ireland Holdings is the foreign principle based in the Bermudas and owns the intangible property.[27] The royalty fees paid by Google Ireland Limited reduce the corporation’s pre-taxable income in Ireland. In addition, these royalty fees are free from Irish taxes because they are paid to a tax haven country, the Bermudas.[28] However, to avoid Ireland’s withholding tax, the money is transferred to the Google Netherlands Holdings B.V office, which has no employees on record, before it reaches the Bermudas. Once in the Bermudas, the income is untraceable by the IRS because Google Ireland Holdings is an unlimited liability company. Under Irish laws, unlimited liability companies are not required to release certain financial information. This foreign income could be taxed if it funnels back into the United States, but very little of it actually does.[29] This process is so effective, it was estimated that if Google were to pay all of its income at the United States 35

[25] Drucker, Jessie, “Google 2.4% Rate Shows How $60 Billion Lost to Tax Loopholes,” *Bloomberg,* October 21, 2010, http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html.

[26] Drucker, Jessie

[27] Drucker, Jessie

[28] Drucker, Jessie

[29] Drucker, Jessie

percent corporate tax rate, the stock price would drop somewhere around one hundred dollars down to the $500[30] range.[31]

Under the U.S. tax laws Google must pay arm's length prices for the rights to the intangible property that was transferred to the Google Ireland Holdings unit. However, the transaction and pricing agreements were approved by the IRS in 2006. According to the Google press release on its fourth quarter 2006 financial results, the following was stated concerning the Advanced Pricing Agreement:

"In December 2006, Google entered into an Advanced Pricing Agreement ("APA") with the IRS in connection with certain intercompany transfer pricing arrangements. The APA applies to the taxation years beginning in 2003. As a result of the APA, we reduced certain of our income tax contingency reserves and recognized an income tax benefit of $90 million in the fourth quarter… In addition, in the fourth quarter, the 2006 R&D tax credit was enacted, which resulted in a $78 million benefit to our provision for income taxes."[32]

Also through this APA, Google has transferred its intangible property rights to Google Ireland Holdings at a price that was not disclosed.[33] Google has received tax benefits and lowered international tax liabilities with the APA. "An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment for a covered transaction if the taxpayer files its tax return for a covered year consistent with the

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[30] Google Finance, G00G -$591 a share (As of November 22,2010)

[31] Drucker, Jessie

[32] Shim, Maria. "Google Announces Fourth Quarter 2006 Financial Results,"investor.Google.com January, 2007, http://investor.google.com/earnings/2006/Q4_google_earnings.html

[33] Drucker, Jessie

agreed transfer pricing method."[34] Its purpose is to eliminate potential transfer pricing disputes in a cooperative manner, but Google has legally abused the APA for large financial benefits.

The IRS has not charged Google with any wrong doing at this time and many other multinational corporations are engaging in similar activities. The frequent abuse of transfer pricing laws has prompted the IRS to reorganize internal divisions to better enforce international tax compliance.

In previous years, the IRS has brought many corporations to court over transfer pricing and intangible property issues and those found guilty of violating regulations have been penalized accordingly. However, cases have been settled outside of tax court for negotiated fines.

In 2006 GlaxoSmithKline plc, one of the world's largest pharmaceutical companies settled a $3.4 billion fine with the IRS for transfer pricing disputes from 1989-2005.[35] The essence of the dispute was over the allocation and transfer prices of Zantac's profits, an ulcer treatment that was produced by Glaxo before the merger into GlaxoSmithKline. If this case would have gone to court, it was reported that GlaxoSmithKline could have faced a potential liability of $ 11.5 billion dollars. The settlement on September 12, 2006 was the largest tax dispute settlement in the IRS' history.[36]

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[34] "Advanced Pricing Agreement Program," IRS Business, Last Updated September 9, 2010, http://www.irs.gov/businesses/corporations/article/0,,id=96277,00.html

[35] Shaw, Helen. "GlaxoSmithKline Settles Largest IRS Tax Dispute," CFO.com, 2003, Oct 20, 2010, http://www.cfo.com/article.cfm/7903093/c_7901942?f=TodayInFinance_Inside

[36] Mortished, Carl, "GSK settles largest tax dispute in history for $3.1bn," *The Sunday Times,* September 12, 2006 Accessed October 27, 2010. http://www.timesonline.co.uk/tol/life_and_style/health/article635994.ece

CHAPTER 4- VAULUING INTANGIBLE PROPERTY

VERITAS SOFTWARE CORPORATION & SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE

UNITED STATES TAX COURT

December 10, 2009, Filed

In the recent case, Veritas Software Corporation & Subsidiaries v. Commissioner of Internal Revenue, the dispute is around intangible property valuation and the arm's length standard . Veritas, a company based in Delaware but operating out of Cupertino, California, develops, manufactures, markets, and sells advanced storage management software products.[37]

The question posed to the Tax Court is whether Veritas Ireland, the subsidiary of Veritas, paid an acceptable arm's length payment to Veritas for intangible property. Back in 1999 Veritas Ireland and Veritas U.S. entered into a cost-sharing agreement for all research and development costs. Both parties agreed to "to pool their respective resources and R&D efforts related to software products and software manufacturing processes. They also agreed to share the costs and risks of such R&D on a going-forward basis."[38] This agreement led to the buy-in payment in 2000 of $166 million that Veritas Ireland paid to Veritas U.S. for the preexisting intangible property. However, in 2002 the amount was adjusted to $118 million. The IRS inspected the tax returns of Veritas U.S. for 2000 and 2001, determined the buy- in valuation was not in

[37] "Veritas Software Corp. v. Comm'r," United States Tax Court. 2009 U.S. Tax Ct. LEXIS 34; 133 T.C. No. 14; December 10, 2009, Filed. No. 12075-06.

[38] "Veritas Software Corp. v. Comm'r".

compliance with arm's length standard and issued a notice of deficiency. This initial notice was based on a $2.5 billion valuation, but during trial the IRS lowered its analysis by $825 million.[39]

The IRS expert John Hatch used a discounted cashflow analysis which determined that the appropriate buy-in payment would be $1.675 billion, while the initial buy-in payment recorded by Veritas U.S. was 14 times lower.[40] Hatch used a different method of valuation and recent comparable transactions while Veritas U.S. used the comparable uncontrolled transaction method (CUT).

The United States Tax Court determined Hatch's valuation for the buy-in payment was arbitrary, capricious, and unreasonable for several reasons.[41] Hatch's allocation took into account, certain items and products that were of no value. For example he included in the valuation Veritas U.S.'s customer list, customer base and distribution channels.[42] Hatch also used the wrong useful life, discount rate and growth rates. Hatch predicted that between 2001 and 2005, Veritas Ireland's compound annual growth rate was 17.91 percent and that their revenues would increase by 13 percent each year from 2007-2010. However, Veritas Ireland's actual growth rate was only 3.75 percent in 2004-2006.[43] His approach was further denied when Hatch

[39] "Veritas Software Corp. v. Comm'r".

[40] Chung, Kerwin, Hustad, Cindy and Shapiro, Alan, "Tax Court rejects IRS's cost sharing buy-in valuation analysis," *Deloitte, Global Transfer Pricing: Arm's Length Standard*, December/January, 2009/2010, Accessed October 2, 2010. http://www.deloitte.com/assets/Dcom- Global/Local%20Assets/Documents/Tax/Newsletters/ dtt_tax_armslengthstandard_091214.pdf

[41] "Veritas Software Corp. v. Comm'r".

[42] Chung, Kerwin, Hustad, Cindy and Shapiro,Alan.

[43] Chung, Kerwin, Hustad, Cindy and Shapiro,Alan.

himself stated at the trial that "he did not have an opinion as to whether his methodology captured the synergistic value of the transferred intangible."[44]

The Tax Court ruled the buy-in payment was best valued using Veritas's comparable uncontrolled transaction method with a few adjustments and rejected the IRS's allocation. [45]

CHAPTER 5- COST SHARING AGREEMENTS

XILINX INC. AND SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE,

UNITED STATES TAX COURT

August 30, 2005, Filed

In the case between Xilinx, Inc and Consolidated Subsidiaries V. Commissioner of Internal Revenue, the IRS questions the allocation of certain research and development costs in a cost sharing agreement.

In 1995, Xilinx, Inc and Xilinx Ireland entered into a Cost and Risk Sharing Agreement, which provided that all rights, title and interests in new technology developed by either Xilinx or Xilinx Ireland would be jointly owned. Under this agreement, costs directly related to research and development, indirect costs, and any other costs related to the development of intangible property, were to be shared. In 1997, 1998, and 1999, Xilinx wrote off roughly $41 million, $40

[44] Chung, Kerwin, Hustad, Cindy and Shapiro,Alan.

[45] "Veritas Software Corp. v. Comm'r".

million and $96 million, respectively.[46] These deductions were recorded as business expenses based on employees' exercises of nonstatutory stock options, disqualifying dispositions of incentive stock options and employee stock purchase plans. In addition Xilinx claimed a research and development credit of $34 million, $23 million and $27 million for the same reasons.[47]

The IRS issued a notice of deficiency for Xilinx's tax years of 1997, 1998, 1999. The notice challenged that the employee stock compensations issued to the employees working in research and development, should be shared between Xilinx and its subsidiary.[48] If shared, Xilinx Inc's deductions would decrease and taxable income would increase.

The tax court issued the opinion that with respect to employee stock options, two unrelated parties would not share the costs at arm's length. Under the Code of Federal Regulations- title 26 Internal Revenue, cost sharing agreements between two related parties are to reflect how two unrelated parties share costs with respect to arm's length pricing. The court concluded that the IRS claims were arbitrary and capricious.[49]

The IRS appealed to the U.S. Court of Appeals and questioned whether all costs are to be shared between related parties or if all transactions between the related parties are to mirror unrelated parties at arm's length. The IRS concurs that employee stock options are costs not

[46] "Xilinx Inc. v. Comm'r," United States Tax Court. 125 T.C. 37; 2005 U.S. Tax Ct. LEXIS 24; 125 T.C. No. 4; August 30, 2005, Filed; As Amended, September 29, 2005. As Amended, September 15, 2005. Reversed by, Remanded by Xilinx, Inc. v. Comm'r, 567 F.3d 482, 2009 U.S. App. LEXIS 11118 (9th Cir., 2009) Affirmed by Xilinx, Inc. v. Comm'r, 2010 U.S. App. LEXIS 5795 (9th Cir., Mar. 22, 2010) Nos. 4142-01, 702-03.

[47] "Xilinx, Inc. v. Comm'r".

[48] "Xilinx, Inc. v. Comm'r".

[49] "Xilinx, Inc. v. Comm'r".

shared between unrelated parties but argues that under 26 C.F.R. § 1.482-7(d)(1)- Sharing of Costs, employee stock options are costs shared between related parties.[50]

A cost sharing agreement requires related parties to share only the costs that unrelated parties would share. However, under § 1.482-7(d)(1), the regulations state that related parties in a cost sharing agreement must share all costs relating to the development of intangible property.[51]

The court determined that the employee stock options exercised in this case, are costs related to intangible property development and must be shared between the two parties. The court's opinion was that § 1.4821(b), which states the arm's length standard should apply "in every case," was incompatible with § 1.482-7(d)(1), which states "all costs" are to be shared in a cost sharing agreement.[52] Therefore, under such circumstances, § 1.482-7(d)(1), the more specific should triumph. The ruling of the tax court was reversed.[53]

But in January of 2010 the U.S. Court of Appeals for Ninth Circuit, withdrew the previous decision and issued a new opinion on March 22. The Court's new opinion holds that the stock-based compensation does not need to be included in the research and development costs in a cost sharing agreement between two related parties.[54]

[50] Klitgaard, Mark, Morrison, Phillip and Shapiro, Alan, "Ninth Circuit affirms Tax Court in Xilinx," *Deloitte, Global Transfer Pricing: Arm's Length Standard,* April/May 2010, Accessed October 12, 2010. http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Newsletters/ dtt_tax_armslen gthstandard_100412.pdf

[51] "Xilinx, Inc. v. Comm'r," United States Court of Appeals for the Ninth Circuit. 567 F.3d 482; 2009 U.S. App. LEXIS 11118; 2009-1 U.S. Tax Cas. (CCH) P50,405; 103 A.F.T.R.2d (RIA) 2388; March 12, 2008, Argued and Submitted, San Francisco, California; May 27, 2009, Filed; Opinion withdrawn by Xilinx, Inc. v. Comm'r, 592 F.3d 1017, 2010 U.S. App. LEXIS 778 (9th Cir. Cal., 2010). No. 06-74246, No. 06-74269

[52] "Xilinx, Inc. v. Comm'r," United States Court of Appeals for the Ninth Circuit. May 27.

[53] "Xilinx, Inc. v. Comm'r," United States Court of Appeals for the Ninth Circuit. May 27.

[54] Klitgaard, Mark, Morrison, Phillip and Shapiro, Alan.

Judge Fisher wrote in his opinion that the regulations are “hopelessly ambiguous”[55] and concluded that “the ambiguity should be resolved in favor of what appears to be the commonly held understanding of the meaning and purpose of the arm’s length standard prior to this litigation.”[56] Fisher seemed to have been influenced by the IRS’s troubles to validate their reasoning. He states that “the Commissioner’s [IRS’s] attempts to square the “all costs” regulations with the arm’s length standard have only succeeded in demonstrating that the regulation are at best ambiguous.”[57] The current regulations make it difficult for courts to issue an opinion. In addition, the regulations may not be universally understood by both taxpayers and the IRS. The current regulations are not clear to taxpayers on how transfer pricing decisions affect their firms. [58] Finally Judge Fisher affirms by stating, “Xilinx’s understanding of the regulations is more reasonable even if the Commissioner’s [IRS’s] current interpretation may be theoretically plausible.”[59]

[55] Fisher, C Raymond, “Xilinx, Inc. v. Comm'r,”United States Court of Appeals for the Ninth Circuit. 598 F.3d 1191; 2010 U.S. App. LEXIS 5795; 2010-1 U.S. Tax Cas. (CCH) P50,302; 105 A.F.T.R.2d (RIA) 1490; March 12, 2008, Argued and Submitted San Francisco, California; March 22, 2010, Filed. No. 06-74246, No. 06-74269

[56] Fisher, Raymond C.

[57] Fisher, Raymond C.

[58] Klitgaard, Mark, Morrison, Phillip and Shapiro, Alan.

[59] Fisher, Raymond C.

CHAPTER 6- THE ARM'S LENGTH STANDARD

NATIONAL SEMICONDUCTOR CORPORATION AND

CONSOLIDATED SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE

UNITED STATES TAX COURT

May 2, 1994, Filed

In National Semiconductor Corporation and Consolidated Subsidiaries V. Commissioner of Internal Revenue, the issues surround arm's length pricing and comparable transactions.

National Semiconductor Corporation's (NSC) headquarters is located in Santa Clara, California and manufactures semiconductors as well as specializes in analog equipment and subsystems. The deficiency of reallocated income filed by the IRS for the taxable years of 1978-1981, totaled $83.1 million. These deficiencies were all concerning NSC's six subsidiaries located in Southeast Asia.[60] These subsidiaries purchased semiconductor material from NSC, packaged them and sold a majority of their finished products back to NSC. Under the transfer pricing system used by NSC, their United States wafer manufacturing business sustained

[60] "National Semiconductor Corp. v. Commissioner," United States Tax Court. T.C. Memo 1994-195; 1994 Tax Ct. Memo LEXIS 199; 67 T.C.M. (CCH) 2849; May 2, 1994, Filed; As Corrected May 2, 1994. Docket Nos. 4754-89, 8031-90

operating losses from the sale of semiconductor dies and material to its Asian Subsidiaries, while the subsidiaries recorded a profit during 1978-1981.[61]

The issue presented to the United States Tax Court was whether the transactions between NSC and their six Asian Subsidiaries were in compliance with arm's length standard under section 482.[62] NSC claims that under the comparable uncontrolled transactions method, they have proven the unrelated transaction used for comparison satisfies the arm's length standard. The IRS argues otherwise, stating that the deficiencies should be upheld or that NSC must adopt the proposal by the IRS expert.[63]

NSC asserted that the comparable transactions used were transactions involving "high-volume, continuing relationships between leading U.S fabricators and Asian contract packagers."[64] But the IRS claims that these transactions differed in "volume, market level, and type of customer" and "the proposed prices included charges unrelated to assembly or testing."[65] The IRS indicated one of the comparable transactions, Motorola and Anam/Amkor, contained packaging terms that were materially different and could not be monetarily quantified.

The Tax Court ruled that neither side had adequate evidence and proven their argument. The court considered other valuation analysis methods from both the NSC and the IRS experts but agreed with none of them.

The court decided that based on the relationship between NSC and its Asian Subsidiaries, it is unrealistic that the transfer prices used would result in operating losses for the parent

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[61] "National Semiconductor Corp. v. Commissioner."

[62] "National Semiconductor Corp. v. Commissioner."

[63] "National Semiconductor Corp. v. Commissioner."

[64] "National Semiconductor Corp. v. Commissioner."

[65] "National Semiconductor Corp. v. Commissioner."

company while the subsidiaries incur high profits. The court made appropriate adjustments to bring the pricing closer to reasonable arm's length standards. The court adjusted Horst's (IRS expert) analysis to produce a fair adjustment and increased NSC's taxable income by $ 6.96 million, $2.54 million, $8.05 million, $13.54 million, and $9.51 million for the years 1978, 1979, 1980, 1981, and 1982.[66]

DHL CORPORATION AND SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE

UNITED STATES TAX COURT

December 30, 1998, Filed

The topic of discussion in DHL Corporation and Subsidiaries V. Commissioner of Internal Revenue, concerns the allocation of a trademark sale and the arm's length standard.

DHL formed in 1969, in California is a package delivery company. In 1979 Document Handling Limited, International (DHLI) was created in Hong Kong and Middleston, N.V(MNV), Incorporated ran the overseas operations.[67] Up until 1987 DHL and DHLI/MNV financially were separate and did not exchange any fees. DHL ran the United States business and DHLI/MNV ran the international business. In 1990 the two companies entered into an

[66] "National Semiconductor Corp. v. Commissioner."

[67] "Dhl Corp. v. Comm'r," United States Tax Court. T.C. Memo 1998-461; 1998 Tax Ct. Memo LEXIS 461; 76 T.C.M. (CCH) 1122; T.C.M. (RIA) 98461; December 30, 1998, Filed. Tax Ct. Dkt. No. 19570-95. Docket No. 26103-95

agreement that included reciprocal performance standards by way of compensation for any shipment differences.[68]

In the late part of 1989, Lufthansa, Japan Airlines Co, and Nissho Iwai Corp (The Group) all had interest in purchasing DHLI/MNV. On July 9, 1990 DHL granted DHLI to purchase the "DHL" trademark for $20 million dollars.[69] This value of the intangible property was valued and supported by Bain & Co. However, in previous offers, the value of the trademark had been $50 million and $100 million.[70]

The deal for The Group to purchase DHLI/MNV was finalized and the firm was reorganized into DHL International Ltd. On September 17, 1992, DHL International Ltd exercised its option to purchase the "DHL" trademark for $20 million.[71]

The IRS issued a deficiency notice for the tax years 1990-1992. The Tax Court upheld deficiencies and penalties of $59.4 million for trademark valuation. DHL bared the burden of proving arm's length pricing but failed to do so. Therefore, the court supported the income allocation to DHL based on the IRS' $100 million trademark valuation. This valuation was based upon $50 million for domestic trademark rights and $50 million was for overseas trademark rights.[72] DHL appealed.

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[68] "Dhl Corp. v. Comm'r," United States Tax Court.

[69] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit. 285 F.3d 1210; 2002 U.S. App. LEXIS 6687; 2002-1 U.S. Tax Cas. (CCH) P50,354; 89 A.F.T.R.2d (RIA) 1978; 2002 Cal. Daily Op. Service 3097; 2002 Daily Journal DAR 3787; April 9, 2001, Argued and Submitted, San Francisco, California; April 11, 2002, Filed. No. 99-71580, No. 00-70008, No. 99-71592, No. 99-71695

[70] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit.

[71] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit.

[72] "Dhl Corp. v. Comm'r," United States Tax Court.

DHL argued to the U.S. Court of Appeals on April 11, 2002, that the presence of The Group prevented income shifts between DHL and DHLI. This case dealt with a transaction between two related parties and one unrelated party as opposed to just related parties.[73] However, the court does not find the existence of The Group to alter DHL's compliance with the arm's length standard. Thus the court has reason to believe that the trademark value in the deal had significant related party influence. The court confirms the non-arm's length pricing and upholds the $100 million price for the transaction.[74]

DHL contested that the tax court's valuation of the trademark was erroneous. The Appeals Court issued the opinion that "although the tax court painted with a broad brush, that is to be expected given the imprecise art of valuing an intangible asset."[75] DHL could not dispute exact numbers in the valuation and thus had no case.

COMPAQ COMPUTER CORPORATION AND SUBSIDIARIES

v.

COMMISSIONER OF INTERNAL REVENUE

UNITED STATES TAX COURT

July 2, 1999, Filed

The dispute between Compaq Computers and Subsidiaries V. Commissioner of Internal Revenue is whether the income from printed circuit assemblies or PCA's from Compaq's Singapore subsidiary was allocated at arm's length.

[73] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit.
[74] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit.
[75] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit.

Compaq Computers is a Delaware based company with its corporate headquarters located in Houston, who manufactures personal computers (PCs). A part of the central processing unit within the PC is the PCA. Compaq had three sources of PCAs which it used in its PCs: PCAs manufactured by Compaq USA, PCAs purchased from its subsidiary in Singapore, and PCAs purchased from unrelated subcontractors located in the United States. [76] Between the years of 1991 and 1992 half of Compaq's PCA demands were filled by the subsidiary.[77]

The IRS filed a notice of deficiency for taxes payable of $42.4 million for 1991 and $33.5 million for 1992 questioning the transfer pricing used.[78]

Both Compaq U.S. and Compaq Singapore used a standard cost system to track their manufacturing cost of these PCA's. This included assigning specific costs material, labor, and overhead standards. Costs concerning the material and labor costs were based on forecasted production at each of the respected manufacturing locations. In general, the costs to manufacture PCA's were cheaper in Singapore than in Houston.[79]

The prices for PCA's were determined by Compaq U.S. using turnkey pricing. Turnkey is a variation of cost-plus pricing, where a firm accounts for fixed costs by adding the amount paid to the manufacturer to the markup of the good or service. In relation to Compaq's case, unrelated contractors would purchase materials needed to manufacture PCA's from Compaq U.S.'s vendor lists. When Compaq purchased the fully completed PCA's from the unrelated contractors, the turnkey price paid, compensated the subcontracts for materials, labor, overhead and the profit

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[76] "Compaq Computer Corp. v. Commissioner," United States Tax Court. T.C. Memo 1999-220; 1999 Tax Ct. Memo LEXIS 254; 78 T.C.M. (CCH) 20; T.C.M. (RIA) 99220; July 2, 1999, Filed; As Corrected July 9, 1999. No. 24238-96

[77] "Compaq Computer Corp. v. Commissioner."

[78] "Compaq Computer Corp. v. Commissioner."

[79] "Compaq Computer Corp. v. Commissioner."

markup.[80] Because of the competition between unrelated subcontractors, prices were set at market levels in the United States. Compaq U.S. used these market prices to set benchmark prices for the PCA's purchased from Compaq Singapore. However, the prices used for its subsidiary did not include compensation for overtime, changes in material price, setup charges and many other factors determining price.[81]

These transfer prices used in 1991 and 1992 were set using a cost-plus formula. In total during 1991 and 1992, Compaq Singapore's transactions with Compaq U.S. were 101.5 percent and 88.1 percent of Compaq U.S. standard PCA production cost. Compaq Singapore sold PCAs to Compaq U.S. with an average transfer price of 93.9 percent or 6.1 percent less than standard production costs.[82]

The IRS investigation discovered that the purchases from Singapore and other unrelated subsidiaries were almost identical except for some differences in the transactions. The comparable transactions used by Compaq U.S. did not satisfy as arm's length comparables for the purchases of PCA's from Compaq Singapore. Compaq U.S. marked up Compaq Singapore's manufacturing profit by 7.5 percent which produced an aggregate sum of $232 million more for Singapore's PCA's in 1991 and 1992.[83] It was determined that the transfer price used was not at arm's length and the IRS increased Compaq U.S's taxable income in 1991 by $124.4 million and $90.4 million in 1992.[84]

[80] "Compaq Computer Corp. v. Commissioner."
[81] "Compaq Computer Corp. v. Commissioner."
[82] "Compaq Computer Corp. v. Commissioner."
[83] "Compaq Computer Corp. v. Commissioner."
[84] "Compaq Computer Corp. v. Commissioner."

In defense, Compaq U.S. compared its pricing decisions with its standard costs on the turnkey basis. Under the turnkey transactions with unrelated subcontractors, Compaq U.S. bought 3.6 million PCA's worth $597 million dollars in 1991 and 1992.[85]

Comparable unrelated sales are present because of the purchases with the unrelated subcontractors and therefore, the comparable uncontrolled price (CUP) method must be used. Because the PCA's purchased from its subsidiary were different, certain price adjustments had to be made to determine an arm's length price. The IRS determined that Compaq U.S. paid less than arm's length prices to its subsidiaries using the CUP method.

Compaq U.S. argues that the transactions with unrelated subcontractors are consignment purchases and cannot be used as comparables. As a result, the transactions cannot accurately be converted to comparable prices and thus CUP comparison cannot be used. Compaq Singapore's prices should instead be compared with similar industry net profit margins of 17.7 percent.[86] Compaq Singapore's costs were less than other comparable companies; as a result, the transfer prices should be less than prices paid to unrelated subcontractors. The prices paid to Compaq Singapore are consistent with the arm's length standard because it would yield a similar net profit margin. The court affirms Compaq U.S. claims.

[85] "Compaq Computer Corp. v. Commissioner."
[86] "Compaq Computer Corp. v. Commissioner."

CHAPTER 7- SOLUTIONS TO SHIFTING INTANGIBLE PROPERTY

The abuse and exploitation of transfer pricing laws Google, Oracle, and other multinational corporations are engaging in is currently legal. Every quarter and every year these techniques are employed, the country loses a large portion of taxable income abroad. This problem stretches beyond the borders of the United States because corporations are financially motivated by tax incentives and tax havens provided by foreign countries. Since foreign tax rates and regulations are the foundation of the issue, it is difficult to solve.

A recent bill, H.R. 5328: the International Competitiveness Act, was introduced to the House on May 18, 2010 and sponsored by Rep. Lloyd Doggett [D-TX25].[87] The bill's purpose is to reduce the incentive to transfer intellectual property overseas and to reduce international tax avoidance. The bill aims to tax a portion of the income from the intangible property associated with American technology and labor, which has been shifted internationally. The bill itself makes several amendments to the Internal Revenue Code of 1986. As of November 19, 2010, no further action has been taken.[88]

This bill is certainly a step in the right direction to deter corporations from utilizing abusive transfer pricing schemes, but the root of the problem is the high U.S. corporation tax rate. Currently at 35 percent, the United States holds the second highest corporate tax rate among members of the Organization for Economic Co-Operation and Development (OECD). Only Japan taxes at a higher rate, but has plans on lowering it which would leave America at the

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[87] Doggert, Lloyd, "H.R. 5328- International Tax Competitiveness Act 2010", Eleventh Congress, Second Session, May 18,2010. http://www.steptoe.com/assets/attachments/HR5328.pdf

[88] "H.R. 5328- International Tax Competitiveness Act 2010," *Opencongress.org*, November 19, 2010. http://www.opencongress.org/bill/111-h5328/show.

top of the list. Currently, the average corporate tax rate of OECD members is 23 percent and falling.[89] The high corporate tax rate is the underlying reason why U.S based corporations are opting to transfer intellectual property out to countries with lower tax rates. A lower United States corporate tax rate may alleviate transfer pricing problems, encourage foreign investment, as well as ignite job creation in the tough economy. But it is unrealistic that the government will significantly decrease in tax rates so that corporations will have no incentives to ship intellectual property overseas. It is highly unlikely in the near future that U.S. tax rates will be competitive with foreign tax havens.

The amount of taxable income leaking out of the borders and abusing international tax regulations has drawn apprehension from the government and IRS. The current concerns are pointing to a solution that would retain all of the taxable income from the American developed intangible property in this country. From a corporation's point of view, this doesn't appear as a practical solution to put a lock on everything that is researched and developed in this country. Our government should be getting returns on research and development grants but the solution cannot be on the exact opposite side of the spectrum. Adequate leniencies must still be available where corporations are still permitted to transfer intangible property overseas and not be taxed heavily. If not, it will hurt the corporations who are not tax minimizing driven, but business motivated.[90]

One solution would be to take the side of a pharmaceutical company, with respect to the current medical drug patent law, and allow the United States to tax and profit for a limited

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[89] Levin, Sander M., "Hearing on Transfer Pricing Issues," Hearing before the Committee on Ways and Means. U.S. House of Representatives, One hundred Eleventh Congress, Second Session, July 22, 2010. http://waysandmeans.house.gov/Hearings/transcript.aspx?NewsID=11273

[90] Neal, Richard E., "Hearing on Transfer Pricing Issues," July 22, 2010.

number of years. Under the Patient Protection and Affordable Care Act, drug patents can only be active for 12 years, after that, generic drugs are allowed to be manufactured.[91] In transfer pricing terms, it should be that all intangible property that is solely or jointly researched and developed in the United States is subject to taxation for a certain amount of years after the intangible property begins to earn profits. In addition, the intangible property must remain in the United States for its taxable years and only after the time period has expired is the corporation free to transfer the intangible property to a lower tax jurisdiction. This way the United States will be able to tax the intangible property at its most profitable stage and see immediate returns. This time restriction should not be as long as 12 years, because it would considerably alter U.S. based companies' business plans. The government is not after a solution that will significantly deter Google, Oracle or Pfizer from developing intangible property in this country, but one that would put some more money in the government's pockets.

CHAPTER 8- SOLUTIONS TO VAULUING INTANGIBLE PROPERTY

As seen in the Veritas Software Corporation and DHL Corporation cases, discrepancies are inevitable in the valuation of intangible property when sold between related parties. It is clear that the motivation to price intangible property at a lower value is to increase profits for the buyer and decrease taxable income for the seller. With the current transfer pricing regulations, especially related party sales and arm's length standards, the IRS has no choice but to value a corporation's intangible property.

[91] "Implementation Timeline" *Health Reform Source,* Accessed October 27, 2010, http://healthreform.kff.org/ timeline.aspx.

When both the IRS and a corporation dispute an intangible property sale, each presents a valuation to the Tax Court, who determines based on the regulations, which is the most accurate. If neither of the valuations satisfies what the courts deem appropriate, the valuations are modified or adjusted accordingly. Valuation is an imperfect process but there needs to be guidelines for valuing intangible property.

Examining the Veritas Software case, both sides had experts valuing this buy-in payment and the results were on opposites sides of the spectrum. The court ruled out the IRS valuation and determined a few adjustments were needed to correct Veritas's valuation. But another outside expert could have argued another valuation was more accurate.

In the DHL case, after the court decided the initial payment was not at arm's length, DHL wanted to contest the IRS's valuation of the trademark. The court reasoned they had no case because of the "imprecise art of valuing an intangible asset."[92]

There will never be a formula that can correctly and indisputably value all intangible property but guidelines can be set forth to prevent another case like Veritas. One possibility would be a collaboration of the firm's experts and the IRS' experts prior to trial. The IRS could understand how the firm valuated the sale and make changes where they deem appropriate. The underlining incentive for corporations to share intangible property is to be able to distribute

[92] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit. 285 F.3d 1210; 2002 U.S. App. LEXIS 6687; 2002-1 U.S. Tax Cas. (CCH) P50,354; 89 A.F.T.R.2d (RIA) 1978; 2002 Cal. Daily Op. Service 3097; 2002 Daily Journal DAR 3787; April 9, 2001, Argued and Submitted, San Francisco, California; April 11, 2002, Filed. No. 99-71580, No. 00-70008, No. 99-71592, No. 99-71695

developmental risk. But valuation regulations are needed to certify that risk is being shared and not intangible property value at ridiculously low prices.[93]

There is currently another case pending in the United States Tax court relating to buy-in payment valuation. In 2008 the IRS sent a notice of deficiency to Medtronic Inc, a Minneapolis based medical technology company, for the tax years of 1997,1998, and 1999.[94] The notice was for a total deficiency in taxes of $53.6 million concerning intellectual property buy-in payments. Medtronic disputed the claims and according to their 2010 annual report, a settlement agreement is still pending.[95] The main issues are transactions and allocations of income between Medtronic and their wholly owned subsidiary, Tolochenaz, located in Switzerland. In Medtronic's initial petition to the adjustment, they disagreed calling the claims "arbitrary, capricious and unreasonable." Medtronic also claims that the penalties alleged were based on transfer pricing regulations passed in 2005.[96]

The IRS is expected to issue buy-in payments guidelines under the 1996 regulations.[97] These adjustments should provide an improved plan for future intangible valuations.

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[93] Morgan, William R, "Hearing on Transfer Pricing Issues," Hearing before the Committee on Ways and Means. U.S. House of Representatives, One hundred Eleventh Congress, Second Session, July 22, 2010. http://waysandmeans.house.gov/Hearings/transcript.aspx?NewsID=11273

[94] Letzing, John, "For Medtronic, the IRS comes calling – late 'Transfer pricing' at issue as companies seek to lower tax burden," *Marketwatch.com*, October 7, 2008. http://www.marketwatch.com/story/for-medtronic-the-irs-comes-calling-late

[95] "Medtronic 2010 Report" medtronic.com/wcm/groups/mdtcom_sg/@mdt/documents/documents/mdt-2010-annual-report.pdf

[96] Letzing, John.

[97] Chung,Kerwin, Hustad, Cindy and Shapiro,Alan, "Tax Court rejects IRS's cost sharing buy-in valuation analysis," *Deloitte, Global Transfer Pricing: Arm's Length Standard*, December/January, 2009/2010, Accessed October 2, 2010. http://www.deloitte.com/assets/Dcom- Global/Local%20Assets/Documents/ Tax/Newsletters/dtt_tax_armslengthstandard_091214.pdf

CHAPTER 9- SOLUTIONS TO THE ARM'S LENGTH STANDARD

The main purpose of the arm's length standard is to ensure related party transactions are transferred at prices competitive to the open market and to prevent tax evasion.[98] In all the cases examined, the IRS sent a notice of deficiency due to disagreements over arm's length pricing.

Corporations who are issued a notice of deficiency must prove the related party transaction comply with the arm's length standard. Under the various transfer pricing methods, a comparable unrelated party transaction is always needed to determine the arm's length price.[99] The corporations studied have been challenged as to whether the comparable transactions used as proof, abide with the arm's length standard. Each corporation's unique operations and transactions have tested the Tax Court's interpretation of arm's length regulations.

The comparable transactions element in arm's length standards is flawed and ambiguous because large multinational companies survive on unique related business transactions that have no comparables. A determinable arm's length standard transfer price, when no unrelated comparable transaction is present, is impossible. Because of this imperfection, uncertainty surrounds the arm's length standard.

In the case studies, the arm's length standard was the main disagreement in all of the court's decisions. In the Veritas Software case, the IRS questioned if the buy-in payment was in

[98] Parker, Ken. "Arm's Length Principal," October 15, 2010, http://www.ustransferpricing.com/arms_length_principle.html.

[99] "Transfer Pricing Methods," http://www.itinet.org/transferpricing/methods.htm.

accordance with the arm's length standard. This led to a horrendous valuation by the IRS experts which were deemed unreasonable.[100]

The National Semiconductor Corporation case involved determining if the comparable transactions used by NSC were at arm's length. The IRS argued they were not because the transactions were different for a variety of reasons. The court ruled they were not, because NSC was recording a loss when its subsidiaries were boasting profits.[101]

The Compaq case demonstrated that comparable transactions must be identical and yield a similar net profit margin in order to be at arm's length.[102]

In the DHL case, the payment was determined not at arm's length because DHL's trademark was sold at an undervalued price.[103]

The Appeals Court was confused between whether the arm's length standard should apply in all cases or if all costs should be shared in a cost sharing agreement in the Xilinx case. The two regulations conflict because two unrelated parties will never share stock option costs but the costs pertained to research and development.[104]

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[100] "Veritas Software Corp. v. Comm'r," United States Tax Court. 2009 U.S. Tax Ct. LEXIS 34; 133 T.C. No. 14; December 10, 2009, Filed. No. 12075-06.

[101] "National Semiconductor Corp. v. Commissioner," United States Tax Court, T.C. Memo 1994-195; 1994 Tax Ct. Memo LEXIS 199; 67 T.C.M. (CCH) 2849; May 2, 1994, Filed; As Corrected May 2, 1994. Docket Nos. 4754-89

[102] "Compaq Computer Corp. v. Commissioner," United States Tax Court. T.C. Memo 1999-220; 1999 Tax Ct. Memo LEXIS 254; 78 T.C.M. (CCH) 20; T.C.M. (RIA) 99220; July 2, 1999, Filed; As Corrected July 9, 1999. No. 24238-96

[103] "DHL Corp. v. Comm'r," United States Court of Appeals for the Ninth Circuit. 285 F.3d 1210; 2002 U.S. App. LEXIS 6687; 2002-1 U.S. Tax Cas. (CCH) P50,354; 89 A.F.T.R.2d (RIA) 1978; 2002 Cal. Daily Op. Service 3097; 2002 Daily Journal DAR 3787; April 9, 2001, Argued and Submitted, San Francisco, California; April 11, 2002, Filed. No. 99-71580, No. 00-70008, No. 99-71592, No. 99-71695

[104] "Xilinx, Inc. v. Comm'r," United States Court of Appeals for the Ninth Circuit. 567 F.3d 482; 2009 U.S. App. LEXIS 11118; 2009-1 U.S. Tax Cas. (CCH) P50,405; 103 A.F.T.R.2d (RIA) 2388; March 12, 2008, Argued and Submitted, San

With the recent withdrawal of Xilinx's court decision, this could be an opportune time for the IRS and government to reevaluate the arm's length regulations. If they determine that the arm's length standard is an ineffective enforcement of transfer pricing regulations, then other options must be explored.

Formulary apportionment has been a solution suggested to dethrone the arm's length standard. Currently all United States based multinational corporations are required to declare profits in each separate international tax jurisdiction in which a subsidiary is present. With formulary apportionment a formula would allocate a firm's total income by determining the percentage of economic activity each subsidiary and parent contributes to the corporation and pay taxes accordingly.[105] This would decrease incentive to move economic activity and income to lower tax jurisdictions because the tax liability of a location is based on the real economic activity. This formula would be measured by a percentage of sales, payroll, property and capital stock.[106] If adopted, multinational corporations could no longer manipulate transfer prices for financial benefits.[107] It would also be the end to the strategies used by corporations like Google and Oracle and the arm's length standard.

Francisco, California; May 27, 2009, Filed; Opinion withdrawn by Xilinx, Inc. v. Comm'r, 592 F.3d 1017, 2010 U.S. App. LEXIS 778 (9th Cir. Cal., 2010). No. 06-74246, No. 06-74269

[105] Tax Policy Center, "International Taxation: How would formulary apportionment work?" in The Tax Policy Briefing Book: A Citizens' Guide for the 2008 Election, and Beyond, 2008. http://www.taxpolicycenter.org/briefing-book/key-elements/international/formulary-apportionment.cfm.

[106] Morse, Susan C, "Revisiting Global Formulary Apportionment," August 10,2010. http://works.bepress.com/cgi/viewcontent.cgi?article=1005&context=susanmorse

[107] Tax Policy Center, "International Taxation: How would formulary apportionment work?"

For example in NCS's situation, NCS was selling material and semiconductor dies to its Asian subsidiary who packaged and sold the products back to NCS at higher prices. NCS then sold their product to customers and recorded a higher profit for the subsidiaries.

This system being incorporated in the United States is a plausible option but it would take international cooperation for it to be successful. If only the U.S. switches to a formulation apportionment system and the OECD continues with arm's length pricing, U.S. corporations could face double taxation. However the European Union has considered switching and along with the United States, could raise enough support of other countries to make formulation apportionment the international standard.[108] The difficulty of setting up such a system could also pose problems for the involved governments and corporations. The entire business structure of these corporations would undergo drastic changes and new accounting standards would have to be put in place. Determining the actual formula and formula weights could pose problems as well. Implementing such an international system is a daunting task and its reward must be compared to its costs.

CHAPTER 10-CONCLUSION

Laws and regulations have flaws and are not perfect. But what makes laws and regulations powerful is their ability to successfully enforce, regulate and penalize those who choose to break them. Most laws have been broken at one point or another and they will continue to be broken for as long as this world exists. Transfer pricing regulations are no different. The current system has flaws as loopholes are being exploited by corporations for financial benefits.

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[108] Durst, Michael, "It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws," *Tax Justice Network*, January 18, 2010 http://www.taxjustice.net/cms/upload/pdf/Michael_Durst_ summary.pdf

The current transfer pricing system is in no ways perfect but revisions can be made to better enforce the laws. With the current debt the United States is facing, corporations legally evading $60 billion worth of taxes a year are not helping the cause. The government needs to implement a regulation or lower corporate tax rates to deter companies from allocating profits to lower tax jurisdictions.

Valuation of intangible property transactions will never be a perfect science. However, regulations of these sales are to ensure intangible property is being shifted for the right reasons. The IRS and government need to implement valuation guidelines to confirm the sales between related parties are at open market values.

Along with the valuation of intangible property, the arm's length standard has been at the core of debates concerning current transfer pricing problems. The ambiguity and complexity of regulation of the arm's length standard is the fundamental flaw. There is no arm's length proof or evidence in related party transactions because comparables simply do not exist.

But will a new system like formulary apportionment solve the transfer pricing woes? Probably not. In this world, corporations are always looking for loopholes to gain financial advantages over competitors and pay better returns to investors. The United States transfer pricing system can only be enforceable if it is reasonable and understood by taxpaying corporations and judges. Rather than developing new laws and regulations, the government should continue with the arm's length standard but clarify ambiguities and formulate a better plan to enforce regulations.

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