TAX DEVELOPMENT JOURNAL

VOLUME 7 SPRING 2017 28-57

REVIVING TRANSFER PRICING ENFORCEMENT THROUGH FORMULARY APPORTIONMENT

Paul A. Blay, Esq.[*]

The international tax system is fundamentally flawed and large multinational enterprises exploit these flaws to drastically reduce their effective tax rates. Data indicates that the most powerful tool for multinational enterprises to reduce their tax liabilities is arm's-length transfer pricing. The arm's-length standard is a relic forced upon the world until it became the norm for most countries. An attractive alternative to arm's-length transfer pricing is transfer pricing based upon formulary methods. Though imperfect and maligned by the Treasury and practitioners, formulary apportionment goes a long way in alleviating the problems created under the arm's-length standard, including its inability to address the intercompany pricing of intangibles.

The global financial crisis of 2007-2008 created a unique opportunity to address this flaw in the international tax system. In the wake of the crisis and through a slow economic recovery, politicians across the world grilled multinational enterprises for their exploitation of weaknesses in the international tax regime and called on the OECD to take action to strengthen it. In 2013, the OECD responded with an ambitious Action Plan and followed up with bold discussion drafts that hinted at an embrace of formulary methods when transactional methods proved insufficient. Disappointingly, the OECD backed away from this position in its final transfer pricing reports in 2015 due to immense pressure that largely came to the United States. The OECD's final reports reaffirm its adherence to the arm's-length standard and promulgated a watered-down version of country-by-country reporting. The door is closing fast for the OECD to make the changes necessary to address one of the greatest weaknesses of the current international tax regime.

[*] Paul A. Blay is a member of the Florida Bar, a candidate for a LL.M. in Taxation (2017) at the University of Florida Levin College of Law, Gainesville, Florida, and a Research Assistant for Professor Martin J. McMahon.

INTRODUCTION

In February 2008, Edward Kleinbard, then chief of staff of the Joint Committee on Taxation, declared that "transfer pricing enforcement is dead."[1] Although concern about base erosion and profit shifting (BEPS) is not new in international tax,[2] recent developments have led politicians to refocus on the issue.[3] From scrutiny of the effective tax rates of Starbucks, Google, and Apple[4] to reports by the Congressional Research Service (CRS)[5] and the Organisation for Economic Co-operation and Development, (OECD),[6] BEPS is in the spotlight once again. Since OECD countries combat transfer pricing abuse through rules based on the arm's-length standard,[7] academics, politicians, and tax professionals are calling the arm's-length standard a failure.[8] These critics often advocate for formulary apportionment to replace the arm's-length standard, claiming that formulary apportionment will significantly reduce BEPS.

As part of a project to address BEPS, the OECD developed an Action Plan on Base Erosion and Profit Shifting (Action Plan) in 2013 that outlines actions to combat BEPS.[9] The OECD issued final reports in 2015, promulgating proposals related to almost every item of the Action Plan

---

[1] Jon Almeras, *Tax Revenue Sets Sail for Foreign Shores*, 118 TAX NOTES 1061 (MAR. 10, 2008).

[2] In May 1996, the OECD started the Harmful Tax Competition initiative to address BEPS, though the initiative fell short of any substantive reform.

[3] *See* discussion *infra* Section II.C.

[4] *Offshore Profit Shifting and the US Tax Code-Part 2: Before the Senate Permanent Subcomm. on Investigations of the Senate Comm. on Homeland Sec. & Gov't Affairs*, 113th Cong. (2013) [hereinafter "*Subcommittee Report Part 2*"].

[5] The CRS is a legislative branch within the Library of Congress that provides policy and legal analysis to committees and members of the House of Representatives and the Senate. *See* Library of Congress, *Library of Congress-Congressional Research Service Careers*, http://www.loc.gov/crsinfo/ (last visited Jan. 3, 2017).

[6] The OECD was originally the Organisation of European Economic Cooperation (OEEC), and was founded in 1948 to administer the Marshall Plan. Inspired by its success and hoping to carry the cooperative work on a global scale, the United States and Canada joined the OEEC members to form the OECD in 1961 with the goal of promoting peace by fostering economic cooperation and development. The OECD currently has 34 members. *See* OECD, *About OECD-History*, http://www.oecd.org/about/history/ (last visited Jan. 3, 2017). During the period that the congressional hearings were conducted and CRS issued its report, the OECD issued its own report regarding BEPS. *See* OECD, *Addressing Base Erosion and Profit Shifting* (2013), *available at* http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/addressing-base-erosion-and-profit-shifting_9789264192744-en#page1 [hereinafter "*BEPS Report*"].

[7] The arm's-length standard is the guiding principle in the U.S. Treasury Regulations for the implementation of I.R.C. § 482. *See* Treas. Reg. §§ 1.482-1-1.482-9.

[8] *See generally infra* Section II.D.

[9] See OECD, *Action Plan on Base Erosion and Profit Shifting* (2013), *available at* http://dx.doi.org/10.1787/9789264202719-en [hereinafter "*Action Plan*"].

(Final Reports).[10] In the Action Plan, the OECD directly speaks to critics of the arm's-length standard, stating that, "rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system."[11] However, the Action Plan also hints at an alternative to the arm's-length standard by saying, "[n]evertheless, special measures, either within or beyond the arm's-length principal, may be required . . . ."[12]

Perhaps more importantly, the idea of using formulary apportionment has gained ground in the United States, a country that has traditionally been the strongest advocate among the OECD member countries of the arm's-length standard.[13] The House Ways and Means Committee looked favorably upon proposals to replace the arm's-length standard with formulary apportionment in its 2010 hearings on the perceived underreporting of income in the United States (2010 CRS Report).[14] The CRS offered formulary apportionment as one of several potential approaches to address corporate profit shifting in its 2013 report about international tax avoidance (2013 CRS Report).[15]

The OECD, with the full support of the United States, can revive transfer pricing enforcement by abandoning the arm's-length standard and adopting formulary apportionment to allocate income of multinational enterprises (MNEs). Section I of this paper defines BEPS and transfer pricing and examines its impact on tax revenues. Section II discusses how the arm's-length standard was originally adopted, how it operates today, and why it receives so much criticism. Section III describes formulary apportionment. Using a variation on the profit split method (a form of formulary apportionment), this article demonstrates that formulary apportionment addresses the fundamental flaws in the arm's-length standard. Section IV explores criticisms of formulary apportionment, establishing that these criticisms lack substance and questioning the motives of critics. Section V considers the OECD BEPS project and explains that, while the OECD still openly adheres to the arm's-length standard, its recent actions have laid the groundwork for the adoption of

[10] *See, e.g.*, OECD, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project* (2015), *available at* http://dx.doi.org/10.1787/9789264241244-en [hereinafter "*Final Report on Transfer Pricing*"].

[11] *Action Plan*, *supra* note 9, at 20. The OECD reiterated its position at the TP Minds America Transfer Pricing summit held in 2014, stating that the OECD had considered a different approach to combat BEPS but decided that a switch to formulary apportionment would not solve the problem. *See* Dana L. Glenn, *Formulary Apportionment No Solution to BEPS, OECD Official Says*, 73 TAX NOTES INT'L 692 (Feb. 21, 2014).

[12] *Action Plan*, *supra* note 9, at 20.

[13] Stanley Langbein, *The Unitary Method and the Myth of the Arm's Length*, 30 TAX NOTES 625, 627 (Feb. 17, 1986).

[14] *Present Law and Background Related to Possible Income Shifting and Transfer Pricing: Before the H. Comm. on Ways and Means*, 111th Cong. (2010).

[15] JANE G. GRAVELLE, CONG. RESEARCH SERV., TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 26 (2013).

formulary apportionment. This article concludes that the OECD should take a much bolder stance than it has in the BEPS project by replacing the arm's-length standard with a transfer pricing regime based on formulary apportionment.

I. BEPS & TRANSFER PRICING--IS IT REALLY THAT BAD?

BEPS is a variant of the classic double nontaxation problem.[16] According to the Action Plan, "BEPS relates chiefly to instances where the interaction of different tax rules leads to double non-taxation or less than single taxation. It also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place."[17]

Transfer pricing is "the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization."[18] Without any transfer pricing rules, a MNE would be allowed to shift income from a high-tax jurisdiction to a low-tax jurisdiction in order to reduce the MNE's effective tax rate. For example, consider a MNE that is subject to a tax rate of 40 percent in country *A*. The MNE's subsidiary is subject to a tax rate of 10 percent in country *B*. If the MNE reports income of $700 million in country *A* and the subsidiary reports $300 million in country *B*, country *A* will impose a tax of $280 million, and country *B* will impose a tax of $30 million for a total tax liability of $310 million. To reduce its tax rate, the MNE can use transfer pricing to shift its taxable income so that it reports $300 million in country *A* and its subsidiary reports $700 million in country *B*, leading country *A* to impose a tax of $120 million and country *B* to impose a tax of $70 million, for a total tax liability of $190 million. By shifting its income through transfer pricing, the MNE managed to reduce its tax liability by $120 million. As can be seen from the example, transfer pricing is one of the methods by which BEPS occurs. But how bad is the effect of BEPS? In order to answer that, we examine the U.S. experience with BEPS.

The primary method of empirical estimation of BEPS comes from two often cited studies by Hines & Rice[19] and Grubert & Mutti.[20] The Hines & Rice study estimated a semi-elasticity of BEPS in the United

---

[16] References to double taxation and double nontaxation refer to an entity's income subject to taxation in multiple jurisdictions and income that is not subject to tax in any jurisdiction due to the different ways multiple jurisdictions treat the entity's income.
[17] *Action Plan*, *supra* note 9, at 10.
[18] MARC M. LEVEY & STEVEN C. WRAPPE, TRANSFER PRICING: RULES, COMPLIANCE, AND CONTROVERSY 2 (Kristina Kulle ed., 4th ed. 2013).
[19] James R. Hines, Jr. & Eric M. Rice, *Fiscal Paradise: Foreign Tax Havens and American Business*, 109 Q. J. OF ECON. 149-82 (1994).
[20] Harry Grubert & John Mutti, *Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making*, 73 REV. OF ECON. & STAT. 285 (1991).

States to be 2.25.[21] That means that a 10 percent increase in tax incentive (defined as the difference in statutory tax rate between a parent and its affiliate)[22] to shift income from a U.S. parent to its foreign affiliate leads to a 22.5 percent increase in income reported by the affiliate. However, these early studies were subject to significant limitations in terms of data that was available.[23] With greater data available from more countries and improved methodologies, newer studies have produced semi-elasticities that were significantly lower, ranging from 1.31 to as low as .4.[24] A more recent study by Heckemeyer & Overesch collected 238 different semi-elasticities from 25 different academic studies about profit shifting.[25] Using a "meta-regression" approach, the study found a consensus of a semi-elasticity of .8 across all of the studies measured, which would imply that a 10 percent increase in tax incentive to shift income from a U.S. parent to its foreign affiliate leads to only an 8 percent increase in income reported by the affiliate.[26] According to empirical literature, the original estimate of the magnitude of BEPS was nearly three times as great as current empirical studies show. The U.S. Congress, however, paints a different picture.

The 2013 CRS Report claims that, on average, very little tax is paid on the foreign-source income of U.S. corporations.[27] The report does not state an exact number for the lost tax revenue, but a broad range of between $60-$133 billion is estimated.[28] Regardless of the exact number, the OECD outlines several reasons why BEPS is harmful to a nation.[29] First, a country is harmed from having less revenue and higher costs of compliance, and the integrity of its tax system is compromised.[30] Second, individuals are harmed as they are burdened with the increased tax that was avoided by MNEs.[31] Third, MNEs are harmed by acquiring a negative

---

[21] The Hines & Rice study reports a number of different estimates using various approaches; however, Professor Dharmapala reaches a representative semi-elasticity of 2.25 using ordinary least squares. *See* Dhammika Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature* (Coase-Sandor Institute for Law & Economics Working Paper No. 702, 2014), *available at* SSRN: http://ssrn.com/abstract=2373549 or http://dx.doi.org/10.2139/ssrn.2373549.
[22] Note that this is the simplest formulation tax incentive. More complex formulations take account of the overall pattern of tax rates faced by all the affiliates of an MNE. *Id*. at 5.
[23] *Id*. at 8.
[24] *Id*. at 15.
[25] Jost Heckemeyer & Michael Overesch, *Multinationals' Profit Response to Tax Differentials: Effect Size and Shifting Channels* (Jul. 30, 2013), ZEW - Centre for European Economic Research Discussion Paper No. 13-045, *available at* SSRN: http://ssrn.com/abstract=2303679 or http://dx.doi.org/10.2139/ssrn.2303679.
[26] *Id*. at 22-23.
[27] GRAVELLE, *supra* note 15, at 1.
[28] *Id*. at 19-20. *See also* Jane G. Gravelle, *Policy Options to Address Profit Shifting: Carrots or Sticks*, 152 TAX NOTES 121 (July 4, 2016).
[29] *Action Plan*, *supra* note 9, at 8.
[30] *Id*.
[31] *Id*.

reputation for engaging in BEPS but suffer competitively if they cannot or choose not to engage in BEPS.[32] Despite all of the negative effects of BEPS, transfer pricing is only one method to engage in BEPS. In this context, how bad is the effect of transfer pricing?

According to a meta-regression study by Heckemeyer & Overesch, the consensus of studies is that 72 percent of the estimated magnitude of BEPS comes from strategic transfer pricing.[33] A study in early 2010 projected that BEPS, specifically through transfer pricing abuses, denudes the U.S. tax base of at least $28 billion per year.[34]

From a numbers standpoint, the effect of BEPS in the United States does not seem to be overly significant. Though current corporate tax revenue is approximately $340 billion,[35] a $28 billion loss of tax revenue would only represent an 8 percent decrease in tax revenue. This seems consistent with the consensus estimate of a .8 semi-elasticity of BEPS worldwide. In addition, an OECD study found that the United States has one of the highest combined federal and state corporate tax rates in the world at 39.3 percent.[36] This tax rate puts U.S.-based MNEs at a competitive disadvantage to the tune of 8 to10 percent compared to the rest of the world.[37] It is therefore only fair to expect a U.S.-based MNE to do everything at its disposal to be competitive in the global market by bridging that 8 to10 percent gap. The actual amount of lost tax revenue indicates that a reduction in the U.S corporate tax rate to levels on par with the rest of the world would alleviate the problems involved with transfer pricing. However, as discussed later in this article,[38] these averages may be distorted by the extreme tax avoidance of technology companies, such as Microsoft[39] and Apple,[40] the bread and butter of which is intellectual property.

Intellectual property can present major problems for the current transfer pricing regime because it is unique by definition.[41] Because of this uniqueness, it is often impossible "to identify transactions between

---

[32] *Id*.

[33] Heckemeyer & Overesch, *supra* note 25, at 26.

[34] *See* Martin A. Sullivan, Tax Analysts, *Transfer Pricing Costs U.S. at Least $28 Billion*, 57 TAX NOTES INT'L 1112 (Mar. 29, 2010).

[35] INTERNAL REVENUE SERV., DATA BOOK, 2015 (Mar. 2016), https://www.irs.gov/-pub/irs-soi/15databk.pdf.

[36] CYM H. LOWELL & MARK R. MARTIN, TRANSFER PRICING STRATEGIES, 2013 WL 5832439 at 2 (2013).

[37] CYM H. LOWELL & PETER L BRIGER, U.S. INTERNATIONAL TRANSFER PRICING, 1999 WL 257434 at 56 (2013).

[38] *See discussion infra* Section II.D.

[39] *Offshore Profit Shifting and the US Tax Code-Part 1: Before the Senate Permanent Subcomm. on Investigations of the Senate Comm. on Homeland Sec. & Gov't Affairs*, 112th Cong. (2012) [hereinafter "*Subcommittee Report Part 1*"].

[40] *See Subcommittee Report Part 2*, *supra* note 4.

[41] Eduardo Baistrocchi, *The Transfer Pricing Problem: A Global Proposal for Simplification*, 59 TAX LAW. 941, 967 (2006).

unrelated parties involving the transfer of comparable intangible assets."[42] Moreover, intellectual property is becoming more relevant in our global economy and will only continue to grow and frustrate the current transfer pricing regime. Therefore, if nothing is done about the current transfer pricing regime, the United States will continue to bleed a growing percentage of corporate tax revenues, even if the corporate tax rate is lowered. Moreover, the U.S. experience with transfer pricing is just a sample of a global phenomenon.[43] In order to understand the weakness of the arm's-length standard, this paper next explains the origin of the arm's-length standard.

II. ARM'S-LENGTH STANDARD--PAST AND PRESENT

A. *Evolution of the Arm's-Length Standard*

Before World War I, there was little concern for double taxation, because there were few companies that had any global income.[44] After the war, combatant countries imposed new income taxes or raised existing rates.[45] Concerned that the arrival of these taxes could lead to detrimental effects on international commerce, the League of Nations (the League) took action by employing experts to do theoretical studies of double taxation.[46] Based on the results of those studies, the League drafted a model convention that members of the League could adopt to prevent double taxation.[47] The original League model convention did not provide guidance on how to allocate business profits of an enterprise that had permanent establishments in multiple countries. The League, however, recognized the need to address the issue and thus formed a Fiscal Committee. The Fiscal Committee commissioned Mitchell B. Carroll to perform a detailed study of how countries allocate business profits in international transactions and to issue recommendations for international models based on his findings.[48] The result is known as the Carroll report.[49] Before the Carroll report, the community of experts designing the League model conventions appeared to be moving toward some form of formulary apportionment.[50] The Carroll report, published in 1933, and subsequent work of the Fiscal Committee changed this direction by advocating a

[42] *Id*.
[43] *See, e.g.*, Richard Murphy, *Transfer Pricing is Still Dead: The End of Transfer Pricing is Nigh…or Maybe Not*, 73 TAX NOTES INT'L 19 (Jan. 6, 2014).
[44] Langbein, s*upra* note 13, at 629.
[45] *Id*. at 630.
[46] *Id*.
[47] *Id*.
[48] *Id*. at 631.
[49] *Id*.
[50] Pre-existing conventions among Central European powers included an allocation provision that called for formulary apportionment. Also, commentary to the 1928 League model convention indicated a preference for formulary methods in making allocations. *See id*.

separate, independent enterprise approach,[51] which became the basis for the London and Mexico conventions.[52] However, these conventions still recognized a tertiary role for formulary apportionment in allocating business profits and contemplated partial formulary apportionment.[53] Following the London and Mexico conventions, the OECD issued its own model tax treaty in 1963 (OECD Model) which expanded the incorporation of formulary apportionment with the separate independent enterprise approach.[54] For example, Article 7(3) of the OECD Model recognized a role for partial formulary apportionment, and Article 7(4) allowed for the use of formulary apportionment in circumstances on which it was customary.[55] The general acceptance of formulary apportionment methods would remain in international conventions until the 1970's. In order to understand why this changed, this article considers the development of the arm's-length standard in the United States.

A separate, independent enterprise approach, known as the arm's-length standard, first appeared with regulations that accompanied Section 45[56] of the Revenue Act of 1934.[57] The scope and purpose statement of Section 45 was as follows:

> The purpose of section 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer . . . [t]he standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's-length with another uncontrolled taxpayer.[58]

Section 45 of the Revenue Act of 1934 was included in the Internal Revenue Code of 1939. A few decades later, Section 45 of the Internal Revenue Code of 1939 was enacted as Section 482 of the Internal

---

[51] *See* OECD, *Model Tax Convention on Income and Capital 2014*, *available at* http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/model-tax-convention-on-income-and-on-capital-2015-full-version_9789264239081-en#page45 (stating in Article VII that profits of a permanent establishment of a contracting state are allocated to other parts of the enterprise as if it were a separate and independent enterprise) [hereinafter "*OECD Model*"].

[52] Langbein, *supra* note 13, at 638.

[53] *Id*.

[54] *Id*.

[55] *Id*.

[56] Section 45 was the base of what today is section I.R.C. § 482. *See* LOWELL & BRIGER, *supra* note 37, at 3-4.

[57] LOWELL & BRIGER, *supra* note 37, at 4. Though there was no official link between the Carroll report and the adoption by the United States of the arm's-length standard, Professor Langbein notes that "the temporal coincidence is striking." *See* Langbein, *supra* note 13, at 632.

[58] LOWELL & BRIGER, *supra* note 37, at 4 (quoting the Regulations in effect in 1968).

Revenue Code of 1954 with no substantive changes.[59] By the early 1960's, the business climate changed drastically from the conditions under which Section 45 was enacted. World War II and the post-war economic resurgence and subsequent expansion created a different economic order.[60] Pharmaceutical companies developed highly profitable "wonder drugs," and they quickly learned to transfer their legal interests in drug patents to related entities located in countries with low or no taxation.[61] The Kennedy administration and the U.S. Treasury Department realized that Section 482 was not effectively protecting U.S. taxing jurisdiction from U.S. parents shifting income to their related entities, and they decided to take action.[62] The House Ways and Means Committee proposed a bill that, among other things, included a new subsection under Section 482 that would have required a U.S. parent to apportion its income between itself and its related entities according to a formula, unless the U.S. parent could demonstrate that the transaction was made at arm's length (House Bill).[63] The House Bill also provided for a foreign tax credit to any domestic organization to which income was reallocated under the bill providing that if, as a result of any allocation under its provisions, the taxable income of a domestic organization was increased and that of a foreign organization was decreased, any foreign income taxes paid by the foreign organization would be treated as paid by the domestic organization and not paid by the foreign corporation.[64] The majority of the House Bill provisions were rejected,[65] with the Senate stating that Section 482 had sufficient regulatory authority to prevent improper multinational allocations.[66] The conference committee report, rejecting the relevant portions of the House Bill states that they,

> believe[d] that the objectives of section 6 of the bill as passed by the House can be accomplished by amendment of the regulations under present section 482…[but] the Treasury should explore the possibility of developing and promulgating regulations under this authority which would provide additional guidelines and formulas for the allocation of income and deductions in cases involving foreign income.[67]

---

[59] *Id*. at 5.
[60] *Id*.
[61] Michael C. Durst, *Analysis of a Formulary System for Dividing Income, Part II: Examining Current Formulary and Arm's-Length Approaches*, 22 TRANSFER PRICING REP. 270, 279-80 (2013).
[62] LOWELL & BRIGER, *supra* note 37, at 5.
[63] H.R. Rep. No. 10650, 87th Cong., 2d Sess. § 6 (1962).
[64] *Id*.
[65] The surviving portions of the House Bill were passed in the Revenue Act of 1962, which introduced the first version of the Subpart F rules of the Internal Revenue Code.
[66] LOWELL & BRIGER, *supra* note 37 at 5.
[67] H.R. Rep. No. 87-2508, at 18–19 (1962).

The Treasury responded to the congressional refusal to change Section 482 by issuing a revenue procedure in 1963,[68] which embodied the concepts that would form the basis for regulations under Section 482 that were issued in 1968 (the 1968 Transfer Pricing Regulations).[69] However, the Treasury faced a major obstacle in carrying out the intent of Section 6 of the House Bill because of the contemplated foreign tax credit that would be allowed for income reallocated from a foreign corporation to its domestic affiliate.[70] According to Professor Langbein, "[t]he Treasury either did not perceive itself authorized to allow such a credit generally without express statutory authorization, or was concerned with the (potentially large) revenue loss doing so would entail."[71] The Treasury knew that unilaterally reallocating income would lead to double taxation but did not want to cede the taxation of income reallocated to the United States through the new regulations, so the United States began to apply pressure for international conformity with its transfer pricing regime.[72]

The OECD eventually ceded to U.S. pressure to internationalize the transfer pricing approach embraced by the 1968 Transfer Pricing Regulations by recommending changes to its members in its 1979 Transfer Pricing Report.[73] Since the 1979 Transfer Pricing Report was issued, the OECD has continued to track the U.S. approach to transfer pricing, modifying its recommendations to reflect revisions to regulations under Section 482 regulations made in 1994.[74]

A new wave of official attention brought transfer pricing into the spotlight again in the 1980's.[75] The practice of shifting income to low-tax or no-tax jurisdictions through transfers of interests in patents and other technology had become popular outside of the realm of pharmaceuticals.[76] Congress responded with the Tax Reform Act of 1986, adding to Section 482 a requirement that prices charged between related parties for the use of intangible property be commensurate with income.[77] The U.S. Treasury and the Internal Revenue Service published the Study of Intercompany Pricing (White Paper) in 1988 in order to provide preliminary principles that might be part of the regulations to implement

[68] Rev. Proc. 63-10, 1963-1 C.B. 490.
[69] T.D. 6952, 1968-1 C.B. 218 (1968).
[70] Langbein, supra note 13, at 645-47.
[71] *Id*. at 647.
[72] *Id*.
[73] OECD, *Report of the OECD Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises* (1979).
[74] *Compare* OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (1994) *available at* http://www.oecd.org/officialdocuments/-publicdisplaydocumentpdf/?cote=SG/PRESS(94)54&docLanguage=En *with* Inter-company Transfer Pricing Regulations Under Section 482, T.D. 8552, 1994-2 C.B. 93 (1994).
[75] Durst, *supra* note 61, at 281.
[76] *Id*.
[77] Tax Reform Act of 1986, Pub. L. No. 99–514, § 1231(e)(1), 100 Stat 2085 (1986).

the commensurate with income language added to Section 482.[78] Interestingly enough, a principle discussed in the White Paper that was not included in revisions to the Section 482 regulations in 1994 (1994 Transfer Pricing Regulations) was the use of the basic arm's-length return method (BALRM), which is a form of formulary apportionment used when an arm's-length price cannot be determined.[79] The 1994 Transfer Pricing Regulations did follow the White Paper's recommendation to implement a comparable profits method based on net income that involved a detailed factual analysis (known as functional analysis). In addition, the 1994 Transfer Pricing Regulations added the profit split method to the list of approved transfer pricing methods, as well as penalties for understated tax liabilities as a result of transfer pricing.[80]

B. *The U.S. Arm's-Length Standard Today*

In the United States, the arm's-length standard is met 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."[81] The regulations provide six different methods to determine the most reliable price for the transfer of tangible property: the comparable uncontrolled price method, the resale price method, the cost plus method, the comparable profits method, the profit split method, and unspecified methods.[82] As for intangible property, the regulations provide four different methods to determine a reliable transfer price: the comparable profits method, the profit split method, the comparable uncontrolled transaction method, and unspecified methods.[83] Under the best method rule, the regulations require the taxpayer to use the best measure of an arm's-length price under the facts and circumstances.[84]

[78] *See* U.S. DEP'T OF THE TREASURY & INTERNAL REVENUE SERV., *A Study of Intercompany Pricing Under Section 482 of the Code*, Notice 88-123, 1988-2 CB 458 [hereinafter "*White Paper*"].
[79] *Id*. at 515-22.
[80] Durst, *supra* note 61, at 283. *See generally* Monica Brown Gianni, *Transfer Pricing and Formulary Apportionment*, 74 TAXES 169 (Mar. 1996) (detailing the changes introduced with the 1994 Transfer Pricing Regulations).
[81] Treas. Reg. § 1.482–1(b)(1).
[82] Treas. Reg. § 1.482–3(a).
[83] Treas. Reg. § 1.482–4.
[84] Treas. Reg. § 1.482–1(c).

C. *Arm's-Length Standard Under Attack--What is Fueling the Political Fire?*

The current transfer pricing regime based on the arm's-length standard is under attack. MNEs are able to erode their tax bases through transfer pricing, which has attracted significant negative attention within the context of a severe global recession that began at the end of 2007.[85]

In July 2008, the U.S. Treasury Office of Tax Analysis issued a report that found that the tax data they had analyzed suggested potential income shifting through transfer pricing abuses.[86] This report was followed by a report from the Government Accountability Office (GAO) in the same year that demonstrated that MNEs could shift income from high-tax to low-tax jurisdictions through price manipulation.[87] The House Ways and Means Committee joined the fray with its hearings on the role of transfer pricing on the perceived underreporting of income in the United States.[88] The Committee also found that U.S.-based MNEs shifted income through transfers of intangibles to related entities in low-tax jurisdictions, significantly eroding their U.S. tax base.[89]

As the political will to address BEPS gathered momentum in the United States, BEPS awareness increased internationally as well. In the United Kingdom's House of Commons in 2012, Margaret Hodge MP, the chair of the House of Commons Public Accounts Committee, questioned Google, Amazon, and Starbucks regarding their tax affairs.[90] Efforts by Starbucks to voluntarily pay £10 million ($14 million) in addition to their taxes for 2013-2014 were largely met with disdain, with critics pointing out that Starbucks had only paid £8.6 million ($12.4 million) in corporate income taxes since first opening its doors in Britain in 1998.[91] Similarly, a deal between Google and the British government, in which the tech giant will pay £130 million ($185 million) in back taxes covering a ten-year period, has attracted only opprobrium.[92]

After Hodge publicly attacked these companies for the low taxes they paid in the United Kingdom due to their use of transfer pricing and other rules to achieve BEPS, Prime Minister David Cameron, beginning his presidency of the G-8, was pressured to address legal tax avoidance.[93]

---

85 Chris Isidore, *It's Official: Recession since Dec. '07*, CNN MONEY.COM (Dec. 1, 2008), http://money.cnn.com/2008/12/01/news/economy/recession/.

86 MICHAEL MCDONALD, U.S. DEP'T OF THE TREASURY, INCOME SHIFTING FROM TRANSFER PRICING: FURTHER EVIDENCE FROM TAX RETURN DATA (2008).

87 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-778, BUSINESS AND TAX ADVANTAGES ATTRACT U.S. PERSONS AND ENFORCEMENT CHALLENGES EXIST (2008).

88 *Supra* note 14.

89 *Id*.

90 Murphy, *supra* note 43.

91 *Starbucks Agrees to Pay More Corporation Tax*, BBC News (Dec. 6, 2008), http://www.bbc.com/news/business-20624857.

92 Kamal Ahmed, *Google Agrees £130 UK Tax Deal with HMRC*, BBC News (Jan. 23, 2016), http://www.bbc.com/news/business-35381130.

93 Murphy, *supra* note 43.

As a result, the G-8 issued the Lough Erne Declaration,[94] in which G-8 members committed to supporting the OECD's BEPS program initiated by the G-20 and surprisingly called on the OECD to draft a template for country-by-country (CbC) reporting.[95] The OECD had already drafted a report on BEPS in early 2013,[96] and a month after it received its commission from the G-8, the OECD issued its Action Plan.[97]

In anticipation of potential comprehensive international tax reform, the U.S. Permanent Subcommittee on Investigations held hearings to address actions that U.S.-based MNEs used to erode their U.S. tax bases.[98] As part of these investigations, the Subcommittee questioned Microsoft and Hewlett-Packard in 2012[99] and Apple in 2013,[100] in order to analyze how U.S.-based MNEs eroded their U.S. tax base and shifted their profits out of the United States.

In the 2012 hearing, the Subcommittee determined that Microsoft performs 85 percent of its research and development for its intellectual property in the United States.[101] However, Microsoft maintains a worldwide cost-sharing arrangement for its research and development with its related entities in Puerto Rico, Singapore, and Ireland.[102] In exchange for these related entities "sharing" these costs, entities are given the economic rights for certain geographic regions to Microsoft's intellectual property, embodied in Microsoft's software.[103] These related entities manufacture and make copies of the software and resell the product at great profit, while paying lower taxes in the jurisdictions where the related entities are located.[104] For example, in 2011, Microsoft Puerto Rico shared $1.9 billion in research and development costs and reported $4 billion in profits taxed at 1.02 percent in Puerto Rico.[105] Through this form of transfer pricing manipulation, the Subcommittee estimated that Microsoft avoids $4 million in U.S. taxes per day.[106] In the 2013 hearing, the Subcommittee discovered that Apple uses a similar cost-sharing arrangement with its Irish subsidiary.[107] From 2009-2012, Apple was able

---

[94] G8, LOUGHE ERNE DECLARATION (2014), *available at* https://www.gov.uk/-government/uploads/system/uploads/attachment_data/file/207771/Lough_Erne_2013_G8_Leaders_Communique.pdf.
[95] *Id*.
[96] *BEPS Report*, *supra* note 6.
[97] *See generally Action Plan*, *supra* note 9.
[98] *Subcommittee Report Part 1, supra* note 39.
[99] *Id*.
[100] *See Subcommittee Report Part 2, supra* note 4.
[101] *Subcommittee Report Part 1, supra* note 39, at 19.
[102] *Id*. at 20.
[103] *Id*.
[104] *Id*.
[105] *Id*.
[106] *Id*.
[107] *Subcommittee Report Part 2, supra* note 4.

to shift $74 billion in worldwide sales revenue away from the United States into Ireland, where it is subject to very low taxation.[108]

D. *Fundamental Problems with the Arm's-Length Standard*

There are three fundamental flaws with the arm's-length standard: there is a theoretical inconsistency of forcing a MNE to conduct transactions with its related entities at arm's-length, there are costly administrative burdens on authorities and taxpayers in attempting to apply arm's-length prices, and the standard allows for legal tax avoidance.

The most fundamental criticism of the arm's-length standard is that treating members of a MNE as separate entities does not reflect economic reality.[109] In fact, a MNE forms related entities in order to internalize transaction costs that increase the MNE's efficiency in a variety of ways, leading to the "continuum price problem."[110] When comparable products or services can be found, the MNE is not likely internalizing much of its transaction costs, because, if it were, the MNE would have eliminated its competitors that offer the comparable products or services.[111] On the other hand, when there are no comparables, the MNE has been able to internalize a large portion of its costs that drove out competitors and eliminated comparables.[112] Therefore, in the majority of complex transfer pricing cases in which there are no comparables and detailed functional analysis is required, there is no correct transfer price.[113]

Since the majority of complex transfer pricing cases involve transfers with which there are no comparables, taxpayers and tax administrators operate in a very uncertain environment.[114] The result is that neither party knows in advance the outcome of a transfer pricing case, despite efforts by countries to create more certainty. For example, the United States developed a program for advanced pricing agreements (APA) in 1991 and published a revenue procedure to govern the process.[115] The APA process serves both as an advance issue resolution program for taxpayers and helps the IRS develop a consistent approach in resolving transfer pricing issues.[116] However, APAs are of limited duration, are private and expensive and are oftentimes unilateral, which

[108] *Id*. at 29 (note, however, that the European Commission has conclude that $14.5 billion of Apple's tax savings in Ireland constituted an impermissible subsidy; *see* Press Release, European Commission, State aid: Ireland gave illegal tax benefits to Apple worth up to €13 billion (Aug. 30, 2016), http://europa.eu/rapid/press-release_IP-16-2923_en.htm).
[109] Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 148 (1995).
[110] *Id*.
[111] *Id*. at 149.
[112] *Id*.
[113] *Id*.
[114] *Id*. at 150.
[115] Rev. Proc. 91-22, 1991-1 C.B. 526.
[116] LEVEY & WRAPPE, *supra* note 18, at 444.

leaves uncertainty about how another taxing authority may characterize a transaction under its transfer pricing regime.[117] The number of bilateral APAs is increasing, but they suffer the same problems of duration and expense and are limited in scope to the countries agreeing upon the APA. The IRS reported that the second most common Uncertain Tax Position,[118] accounting for nearly 20 percent of all Uncertain Tax Positions through 2014, involved Section 482 transfer pricing issues.[119]

This uncertainty can cause taxpayers to forgo potentially profitable international ventures and can create problems of government planning for future revenue because billions of dollars are in flux.[120] A MNE that decides to undergo the risk of running afoul of the arm's-length standard through internalizing costs with related entities is faced with ever-increasing requirements of extensive contemporaneous transfer pricing documentation in order to be in compliance with the countries in which the MNE operates.[121]

Not only does transfer pricing compliance impose a heavy burden on the taxpayer, but tax administrators shoulder an extensive burden when it comes to trying to enforce the arm's-length standard. Looking once again to the U.S. experience, in 1992 the GAO performed an extensive survey of the administrative cost of the arm's-length standard.[122] It found that the amount in controversy in the Tax Court's docket for transfer pricing cases was $32 billion, with the IRS spending $15 million on expert witnesses alone.[123] The IRS had (and still has) difficulty in successfully litigating these cases.[124] In 2013, the largest increase of the proposed budget for the IRS was $140 million to promote and improve offshore and international compliance.[125]

[117] Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation*, 21 MICH. J. INT'L L. 143, 163-69 (2000).

[118] *See* Ilya A. Lipin, *Uncertain Tax Positions and the New Tax Policy of Disclosure Through the Schedule UTP*, 30 VA. TAX REV. 663, 667 (2011) (defining Uncertain Tax Positions as "items for which tax treatment is unclear due to uncertainty in the law or its applicability to a particular transaction.").

[119] INTERNAL REVENUE SERV., SCHEDULE UTP TY2015 FILING STATISTICS (2016), https://www.irs.gov/businesses/corporations/utp-filing-statistics.

[120] Avi-Yonah, *supra* note 109, at 151.

[121] *See generally* Ernst & Young, *Navigating the Choppy Waters of International Tax*: *2013 Global Transfer Pricing Survey* (2013) (surveying 26 different countries with transfer pricing documentation requirements).

[122] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-92-89, PROBLEMS PERSIST IN DETERMINING EFFECTS OF INTERCOMPANY PRICES (1992).

[123] *Id.*

[124] *See, e.g.*, Altera Corp. & Subsidiaries v. Comm'r, 145 T.C. 91 (2015); Xilinx Inc. v. Comm'r, 567 F.3d 482, 484 (9th Cir. 2009), *rev'd on reh'g*, 598 F.3d 1191 (9th Cir. 2010), *acq. in result*, 2010-33 I.R.B.; Veritas Software Corp. v. Comm'r, 133 T.C. 297, 299 (2009).

[125] INTERNAL REVENUE SERV., FY 2013 BUDGET IN BRIEF (2012), http://www.irs.gov/pub/newsroom/budget-in-brief-fy2013.pdf.

Finally, transfer pricing creates ample opportunities for legal tax avoidance for corporations to reduce their effective tax rates.[126] A recent report published by the Tax Justice Network states:

> [s]ome of these transfer pricing abuses have to do with over-invoicing of goods imports and under-invoicing goods exports, so as to minimize income in higher-tax countries and shift unreported profits abroad. Other transfer pricing abuses involve the (below-market) transfer of intellectual property rights (know-how, brand value, films, patents, and software) to low-tax jurisdictions.[127]

These practices arise because of the joint venture nature of the arm's-length standard, which encourages taxpayers to attribute ownership of valuable intangible property to parties that did not properly bear the deductible cost to develop the intangible (known as the buy-in issue).[128] Though the regulations try to address this abuse by requiring parties contributing pre-existing intangibles to a cost-sharing pool to receive an arm's-length price, buy-in issues are the subject of constant dispute.[129]

Another form of abuse that arises under the arm's-length standard is called "cherry-picking." Under this scheme, MNEs (who have greater insight than administrators on the likelihood of a developing intangible's success) assign intangibles with greater profit potential to cost-sharing arrangements while the intangible is being developed, avoiding the controversy that would arise under the buy-in issue.[130]

III. FORMULARY APPORTIONMENT

Formulary apportionment is often proposed as an alternative to the arm's-length standard. In formulary apportionment, the aggregate income of the parent and related entities of a MNE is divided among tax jurisdictions based on a formula.[131] Formulary apportionment already exists in the United States in the form of the profit split method in the U.S. Treasury Regulations,[132] and there are several other approaches to formulary apportionment.[133] Some of these options include the BALRM

---

[126] *See, e.g.* discussion *supra* notes 101-08.
[127] James S. Henry, *The Price of Offshore Revisited: New Estimates for "Missing" Global Private Wealth, Income, Inequality, and Lost Taxes*, Tax Justice Network (July 2012), *available at* http:// www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_-Revisited_120722.pdf.
[128] Michael C. Durst and Robert E. Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 TAX L. REV. 37, 102 (2003).
[129] *Id*. at 103.
[130] *Id*. at 103-04.
[131] Gianni, *supra* note 80, at 174.
[132] Treas. Reg. § 1.482-6.
[133] Gianni, *supra* note 80, at 174.

and BALRM with profit split, proposed by the White Paper and rejected by subsequent regulations,[134] the three-factor formula used among the states,[135] and allocation based only on sales.[136]

In order to understand how a formulary based system might work, this article examines in more detail the profit split method.[137] The first step is to define the business activity of a MNE among the countries in which the activity is conducted.[138] The activity includes "a group of functions related to the conduct of a particular trade or business to which two or more related parties contribute, determined at the largest level of aggregation of functions performed that will permit reliable identification of such related parties' respective contributions to the functions comprising an activity."[139] Next, that activity is treated as a single taxpayer, and the MNE determines the activity's net worldwide income by subtracting worldwide expenses from worldwide income based on a global accounting system.[140] The last step is to assign normal returns to the location of the costs of producing the income and apportioning residual income based on sales.[141]

Regardless of the factors used to ultimately apportion the income, any form of formulary apportionment addresses the three fundamental flaws of a transfer pricing regime based on the arm's-length standard:[142] the theoretical inconsistency of forcing a MNE to conduct transactions with its related entities at arm's-length, the administrative burden on authorities and taxpayers in attempting to apply arm's-length prices, and legal tax avoidance.

Adopting formulary apportionment means that the artificial legal distinction between a parent and its related entities disappears.[143] As noted above, the primary reason a MNE has related entities is to benefit from internalizing its transaction costs.[144] Forcing firms to allocate the savings they gain from internalizing costs is necessarily arbitrary, because they would not exist if related entities truly operated at arm's-length.[145] By abandoning the legal distinction between the related entity and its parent for the purpose of allocating worldwide income, a transfer pricing regime

---

[134] *White Paper*, *supra* note 78.
[135] Gianni, *supra* note 80, at 166-68.
[136] Jarome R. Hellerstein, Walter Hellerstein, and John A. Swain, *State Taxation, Third Edition* (Thomson Reuters/WG&L, 2016 rev.), ¶ 8.06 [1].
[137] Reuven S. Avi-Yonah, Kimberly A. Clausing and Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 508 (2009) (describing the profit split method and how it may be used as the basis for formulary apportionment).
[138] *Id*.
[139] *Id*.
[140] *Id*.
[141] *Id*.
[142] *See* discussion *supra* Section II.D.
[143] AviYonah, Clausing & Durst, *supra* note 137, at 508.
[144] Avi-Yonah, *supra* note 109, at 148.
[145] *Id.; see also* Avi–Yonah, Clausing & Durst, *supra* note 137, at 507.

based on formulary apportionment aligns tax jurisdictions with the reality of the global economy.[146]

By addressing the theoretical flaw that underlies the arm's-length standard, the difficulties of administration disappear. Formulary apportionment greatly simplifies the process of allocating income to different tax jurisdictions, because it does not involve functional analysis or the cumbersome process of developing an APA.[147] As Professor Avi-Yonah notes, "[t]o determine U.S. tax liability, there would be no need to allocate income or expenses among countries, resulting in far lighter compliance burden for firms."[148] Both tax administrators and taxpayers would spare the expense of lengthy court battles and unpredictable results.[149] Under formulary apportionment, there is no need to allocate expenses, because all a MNE needs to do is calculate its net worldwide income, allocate the income to jurisdictions based on the formula, and then apply the tax rate to the income apportioned to that tax jurisdiction.[150] As for the burden of reporting the factors used in the formula, most formulas require data that are typically already in the taxpayers' books and records.[151] Not only does this simplification allow taxpayers to reduce their costs of compliance with APAs or contemporaneous transfer pricing documentation, taxpayers also save on resources that would have been used to develop elaborate schemes in order to reduce their effective tax rates and the burden on administrators to challenge these schemes. Lastly, formulary apportionment reduces opportunities to manipulate the allocation of income into low-tax jurisdictions because a MNE would be taxed based on its global income, eliminating an avenue to lower its effective tax rate by manipulating an arm's-length price between itself and its related entity.[152]

IV. CRITICISM OF FORMULARY APPORTIONMENT

A. *Criticisms*

Criticism of formulary apportionment largely arises from the experience of formulary methods between the states in the United States. In 1911, Wisconsin became the first state to adopt an individual income tax, pioneering formulary apportionment, which became the norm for state

[146] Avi–Yonah, Clausing & Durst, *supra* note 137, at 507-08.
[147] *Id.*
[148] *Id.* at 512.
[149] *Id.* at 511.
[150] *Id.* at 508.
[151] Michael C. Durst, *Analysis of a Formulary System for Dividing Income, Part III: Comparative Assessment of Formulary, Arm's-Length Regimes*, 22 TRANSFER PRICING REP. 653, 656 (2013).
[152] Avi–Yonah, Clausing & Durst, *supra* note 137, at 511.

taxation.[153] States initially used predominantly single-factor formulas based on either property or sales,[154] but recognition that the single-factor property formula was not well suited to the division of net income among the states and a change in the rationale underlying the state's claim to a portion of the tax base led to adoption of the Massachusetts formula (an equally weighted three-factor formula of property, payroll and sales).[155] After hitting its zenith, the Massachusetts formula was abandoned in favor of statutes adopting the Uniform Division of Income for Tax Purposes Act (UDITPA) or statutes closely analogous to UDITPA,[156] giving much greater weight to the sales factor.[157]

Critics state that formulary apportionment leads to an arbitrary redistribution of the tax base by leaving out market conditions, intangibles, and risk from the formula.[158] This arbitrariness leads to the same ultimate problem that the arm's-length standard faces, i.e., how to handle intangibles.[159] One study found that, based on the empirical literature, the three traditional factors used in formulary apportionment--labor, capital, and sales--fail to explain significant variations in a MNE's profits.[160]

In addition, MNE behavior is guided into moving "factors" that are used in the formula to low-tax jurisdictions in order to lower the MNE's tax liability.[161] A system more in line with the current practice of the states, using a single-factor sales formula or a multi-factor formula giving the majority of the weight to the sales factor, is still subject to factor manipulation under the current title passage rule utilized in U.S. federal income tax law.[162] Although factor manipulation in a sales-based formula may be addressed by treating the sale as occurring at the location of the customer, this method may bring a host of different problems and can also be vulnerable to factor manipulation through the use of intermediary purchasers.[163]

---

[153] Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1058 n.145 (1997).
[154] Hellerstein, Hellerstein & Swain, *supra* note 136 at ¶ 8.06 n. 228.
[155] *Id*. at ¶ 8.06[1].
[156] *Id*. at ¶ 9.01.
[157] Sales weighted formulas are designed to encourage taxpayers to locate in the state because their in-state capital and labor will count relatively less or not at all in determining the taxpayer's in-state income and their sales will count only insofar as they have a market within the state. *See id*. at ¶ 8.06[1].
[158] Garry Stone & Elif Ekmekci-Taskiran, *Formulary Apportionment: The Case of the Missing Income*, 22 TRANSFER PRICING REP. 867 (2013).
[159] LOWELL & BRIGER, *supra* note 37, at 38.
[160] *Id*.
[161] *Id*. *See also* J. Clifton Fleming, Jr., *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on A Pig?*, 36 MICH. J. INT'L L. 1, 35-8 (2014); Altshuler, Rosanne, & Harry Grubert, *Formula Apportionment: Is It Better than the Current System and Are There Better Alternatives?*, 63 NAT'L TAX J. 1145, 1182 (2010).
[162] Treas. Reg. § 1.861-7(c).
[163] Flemming, *supra* note 161, at 41 (stating that a single-factor sales formula with the sale being treated at the location of the customer would violate the principle of ability-to-pay by excluding foreign income of U.S. residents from the U.S. tax base; it would also

This concern misses the mark on the larger problem created by BEPS. MNEs are using BEPS to significantly reduce their worldwide effective tax rates.[164] By utilizing a formula that allocates all of a MNE's worldwide income among various countries, all income will be assigned to *some* jurisdiction,[165] and the formula favors the jurisdiction with more factors of production.[166]

The stronger thrust of this criticism is that MNEs may be encouraged to shift factors to lower-tax jurisdictions. This criticism ignores the expense and logistical difficulty of relocating the factors of production from high- to low-tax jurisdictions[167] and fails to consider the prior experience of the states that indicates that formula factors (payroll, assets, and sales) are not particularly tax sensitive.[168] Moreover, moving to a system of formulary apportionment is bound to cause controversy with low-tax jurisdictions, because the interests of low-tax jurisdictions to attract more business coincides with the interests of MNEs seeking to lower their tax rates.[169] Although greater tension would develop between high- and low-tax jurisdictions if formulary apportionment is adopted, this is a controversy that is primarily political in nature.[170] The bottom line is that high-tax jurisdictions should not avoid developing a more efficient transfer pricing regime based on the possible reactions of low-tax jurisdictions.

Another criticism of formulary apportionment is that the administrative burden of MNEs having to produce the necessary data to determine formulary apportionment would be intolerably high.[171] Tax professionals argue that formulary apportionment would require MNEs to

---

preserve the discrimination against domestic U.S. businesses with exclusively U.S. customers vis-à-vis U.S. MNEs that can use profits from exports and low-taxed foreign operations to cross-subsidize their other U.S. activities; and it would lose revenue, in the form of forgone U.S. residual tax, when compared with a true worldwide system that prohibits deferral and cross-crediting); Ryan Finely, *Is Formulary Apportionment the Solution to BEPS?*, 80 TAX NOTES INT'L 294 (Oct. 26, 2015) (noting that a sales based formula may be subject to tax avoidance strategies using independent distributors located in low-tax jurisdictions and franchising arrangements); Kevin A. Bell, *Move Away from Profit Split Won't Please All: Ex-OECD Official*, 25 TAX MGM'T TRANSFER PRICING REPORT 402 (July 28, 2016) (quoting Mike Cragg of the Brattle Group as saying that the move from three-factor formulas to the single-factor sales formulas reflects a race to the bottom among states, which has led to a tax system that does not reflect generation of income).

164 *Action Plan*, *supra* note 9, at 10.

165 *Id. See also Subcommittee Report Part 2*, *supra* note 4, at 21-25 (describing how Apple was able to avoid tax by related entities not having tax residencies).

166 Kevin A. Bell, *OECD Releases Draft Template on Country-by Country Reporting*, 22 TRANSFER PRICING REPORTS 1214, 1215 (2013).

167 Lee A. Sheppard, Tax Analysts, *News Analysis: Is Transfer Pricing Worth Salvaging?* 67 TAX NOTES INT'L 384 (July 30, 2012).

168 Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base*, 150 TAX NOTES 427 (Jan. 25, 2016).

169 Avi–Yonah, Clausing & Durst, supra note 137, at 520.

170 *Id*.

171 Avi-Yonah, *supra* note 109, at 156.

compile worldwide income and sales data using U.S. GAAP and the U.S. dollar,[172] which in turn, would lead to high compliance costs.[173]

In response, MNEs today presumably already know what their worldwide profit and loss accounts look like on a uniform basis.[174] Additionally, many taxing authorities have the power to require MNEs to produce the necessary information,[175] and this is growing with the adoption of the transfer pricing documentation in the OECD Action Plan No. 13 and its CbC reporting requirement for MNE's with consolidated group revenue of more than €750 million.[176] As of February 3, 2017, 36 countries have final legislation implementing CbC reporting, with an additional 16 countries with draft regulations or legislation and 18 countries anticipated to adopt legislation implementing CbC reporting.[177] The IRS issued Revenue Procedure 2017-23 to implement CbC reporting effective as of January 1, 2016,[178] affecting U.S. persons that are the ultimate parent entities of a MNE group that has annual revenue for the preceding annual accounting period of $850 million.[179] The broad implementation of CbC reporting facilitates the adoption of a formulary apportionment system because the necessary information is already available. Even without the information available in CbC reporting, formulary apportionment is simpler and more easily administered than the current transfer pricing rules, easing the burden of additional compliance costs.[180]

The strongest criticism against changing to a formulary apportionment system is that the arm's-length standard has become the international norm.[181] Whether the Carroll report was correct in asserting that the separate independent enterprise approach was the international norm in 1933,[182] the adoption of the arm's-length standard in the League model conventions, the § 482 regulations, and the subsequent adoption in

---

[172] *Id*.
[173] LEVEY & WRAPPE, *supra* note 18, at 465.
[174] Avi-Yonah, *supra* note 109, at 156.
[175] *See, e.g.,* I.R.C. §§ 6038-6038C (1986).
[176] OECD, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project* (2015), *available at* http://dx.doi.org/10.1787/9789264241480-en [hereinafter "*Final CbC Report*"].
[177] KPMG, *BEPS Action 13: Country Implementation Summary* (2017), *available at* http://www.kpmg-institutes.com/content/dam/kpmg/taxwatch/pdf/2017/beps-action-13-country-implementation-summary.pdf.
[178] Rev. Proc. 2017-23, 2017-7 I.R.B. 915 (2017).
[179] Treas. Reg. § 1.6038-4(h).
[180] J. Clifton Fleming, Jr., *supra* note 161 at 35. *See also* Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 600-01 (2010) (stating that the adoption of formulary apportionment could obsolete more than just the current transfer pricing rules, such as Subpart F rules, depending on the method of applying formulary apportionment and the scope of its international adoption).
[181] Gianni, *supra* note 80, at 179. *See also* Gravelle, supra note 28.
[182] *See* Langbein, *supra* note 13, at 634-38. *See also supra* text accompanying notes 50-52.

the OECD's Transfer Pricing Report in 1979 has solidified the arm's-length standard in the transfer pricing statutes of most nations, Brazil being a notable exception.[183] Although the OECD BEPS discussion draft on BEPS Actions Nos. 8-10 leaned toward a more formulary approach, pressure from the United States led to the OECD explicitly sticking with the current transfer pricing regime based on the arm's-length standard;[184] therefore, an OECD member that unilaterally abandons the arm's-length standard can lead to double taxation.[185] Furthermore, in order to adopt an international transfer pricing regime based on formulary apportionment, countries would need to reach international consensus on the appropriate formula[186] as well as reconcile their differences on how different factors of the formula are defined.[187] Many nations would need to make drastic changes to their current transfer pricing statutes.[188]

Once again, the OECD addresses this criticism with its response to the G8's request for a CbC reporting template,[189] signaling greater cooperation and a willingness to change the international norm. On October 5, 2015, the OECD released its template for CbC reporting.[190] The template includes information for the location of economic activity, i.e., revenue (related and unrelated party), profits, income tax paid and taxes accrued, employees, stated capital and retained earnings, and tangible assets for each tax jurisdiction in which the MNE does business.[191] Though the OECD insists that these factors are part of the template for determining risk assessment, David Ernick of PricewaterhouseCoopers says that these are exactly the same factors a government would want if they were to design a transfer pricing system based on formulary apportionment.[192] The political will for change is

---

[183] *See* Fernanda Amaral & Christina Medeiros, *Brazilian Tax Authorities Accept Independent Report in Transfer Pricing Case*, 2014 WTD 41-12 (Mar. 3, 2014) (describing how Brazil's transfer pricing rules do not follow the internationally accepted arm's-length standard but provide for the use of statutory fixed margins to define the ceiling prices for intercompany import transactions and the minimum gross income floors for intercompany export transactions).

[184] Ajay Gupta, *BEPS: Branding Stasis*, 72 TAX NOTES INT'L 823 (Dec. 2, 2013); David D. Stewart, Tax Analysts, *Stack Describes U.S. Goals and Concerns on BEPS Draft*, 2014 TNT 58-5 (Mar. 26, 2014). *See also* discussion *supra* Section V.

[185] Gianni, *supra* note 80, at 179.

[186] *See id*. (noting that experience between the states has shown that consensus is not always easily achieved).

[187] Joann Martens-Weiner, *Using the Experience in the U.S. States to Evaluate Issues in Implementing Formula Apportionment at the International Level* (OTA Working Paper No. 83. 1999), *available at* https://www.treasury.gov/resource-center/tax-policy/-Pages/tax_analysis_paper.aspx.

[188] *See, e.g.* LOWELL & BRIGER, *supra* note 37, at 50 (describing how the United Kingdom adopted the patent box regime in 2013).

[189] *See* G8, *supra* note 94.

[190] *Final CbC Report*, *supra* note 176.

[191] *Id*. *See also* text accompanying notes 246-50.

[192] Bell, *supra* note 166.

obviously present,[193] and a change of direction by the United States, traditionally the fiercest advocate for the arm's-length standard, would lead the way for a change in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Transfer Pricing Guidelines).[194]

Following the rhetoric of the OECD, critics of formulary apportionment claim that the correct way to address BEPS is to address the flaws within the arm's-length standard, which some countries have already undertaken. For example, the APA program is designed to reduce uncertainty in transfer pricing in the United States. When the program began in 1991, it was understaffed[195] and terribly inefficient for bilateral agreements.[196] This inefficiency was caused by the APA staff working independently of the Competent Authority side of the IRS that negotiates APAs with treaty partners. This separation led the APA staff to develop unrealistic recommended negotiating positions, since the APA staff was bound to analyze each case before it using U.S. law.[197] In order to address this inefficiency, the IRS relocated the APA program to its Large Business and International Division and combined it with the Competent Authority function to create the Advanced Pricing and Mutual Agreement Program (APMA), effective February 27, 2012.[198] The full-time staff increased to 93 professionals by the end of 2015.[199] As a result of these changes, the number of APAs has skyrocketed with 403 bilateral APAs and 229 APAs renewed since the APMA's formation in 2012.[200]

The APA program is obviously an attempt to reduce the cost of transfer pricing caused by uncertainty, but this attempt to improve upon the arm's-length standard is of limited utility because of the costs of obtaining an APA. A regular APA fee is $60,000, while an APA renewal can range from $35,000 for a small business to $60,000 for a non-routine renewal.[201] APAs are granted based on the facts and circumstances of each case, which means that all APAs are limited in their scope.[202] Most APAs are granted for only five years.[203] Further, although bilateral APAs have

[193] *See* discussion *supra* Section II.C.
[194] Avi-Yonah, *supra* note 109, at 157-58; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2010) *available at* http://dx.doi.org/10.1787/tpg-2010-en.
[195] LEVEY & WRAPPE, *supra* note 18, at 226 (noting that the program had 35 full-time staff at the end of 2011).
[196] *Id*. at 445.
[197] *Id*.
[198] *Id*.
[199] INTERNAL REVENUE SERV., ANNUAL APA STATUTORY REPORTS (2016) https://www.irs.gov/businesses/corporations/annual-apa-statutory-reports.
[200] *Id*.
[201] Rev. Proc. 2015-41, 2015-35 I.R.B. 263, §3.02.
[202] *International Tax Issues Related to Globalization: Before Comm. on Finance*, 106th Cong. (1999).
[203] Rev. Proc. 2015-41 § 3, *supra* note 201.

been growing (80 out of 110 APAs in 2015),[204] there have been only 14 multilateral APAs since the program was first introduced in 1991.[205] Of those bilateral APAs, only 40 percent were new APAs and 69 percent were made with Japan and Canada, which means that APAs, already limited by their scope and duration, are also limited in number and location.[206] The statistics also indicate that APAs fail to address the crucial weakness in the current transfer pricing regime, i.e., the valuation of intangibles. In 2015, 75 percent of covered transactions involved tangible goods and services transactions while merely 24 percent of APAs involved the use of intangible property.[207]

B. *Motives*

This paper has discussed how the arm's-length standard has been scrutinized for over 50 years as being insufficient to stop BEPS[208] and how the current transfer pricing regime based on the arm's-length standard is fundamentally flawed.[209] Why do OECD member countries maintain this flawed system? Why are tax professionals so quick to criticize formulary apportionment?[210]

The director of the United Kingdom-based Tax Research Institute, Richard Murphy, described his experience in a presentation he gave about CbC reporting at the OECD public consultation on transfer pricing documentation and intangible assets held in Paris in November 2013.[211] He noted that representatives from Ernst and Young and Deloitte attacked the suggested data for the OECD CbC template, citing concerns about privacy and vulnerability.[212] Murphy noted that, "[w]hat the debate at the OECD revealed was an almost evangelical belief in arm's-length transfer pricing."[213] Murphy gives two reasons why tax professionals adhere to their belief in the arm's-length standard.

First, the arm's-length standard serves MNEs well as it allows them to continue to save large amounts of tax through BEPS.[214] From a certain perspective, tax professionals cannot shoulder all the blame. They are hired in order to maximize tax savings for their clients. The same argument for MNEs to engage in BEPS holds true for the tax professionals who are hired to orchestrate it. If a tax professional refuses to orchestrate

[204] INTERNAL REVENUE SERV., *supra* note 199 (follow "2015" hyperlink).
[205] *Id*.
[206] *Id*.
[207] *Id*.
[208] *See* discussion *supra* Section II.A,C.
[209] *See, e.g.*, Avi-Yonah, *supra* note 109.
[210] *See* discussion *supra* Section IV.A.
[211] Murphy, *supra* note 43.
[212] *Id*.
[213] *Id*.
[214] *Id*.

BEPS for its MNE clients, then another tax professional will take the client.

Tax professionals do not benefit just from orchestrating legal tax avoidance, which brings us to Murphy's second point. He says that tax professionals:

> [H]ave the most to lose from the demise of arm's-length pricing. They have invested the most into this faith system. It is they who are its high priests and the guardians of the purity of form that they expect of all true believers. And it is they who stand to lose most if the vestments of its practice are stripped from them.[215]

A prime example of what is at stake is transfer pricing documentation. The 2014 Transfer Pricing Discussion Draft on Transfer Pricing Documentation and CbC Reporting recognized that many countries adopted extensive transfer pricing documentation rules and, "combined with a dramatic increase in the volume and complexity of international intra-group trade . . . has resulted in a significant increase in compliance costs for taxpayers."[216] These tax professionals benefit by the extra work created through extensive transfer pricing documentation.

As can be seen from the preceding discussion, the arm's-length standard has some heavy hitters in its corners. MNEs will defend the arm's-length standard because it creates opportunities for tax savings through BEPS. Further, tax professionals benefit from orchestrating BEPS for their MNE clients and by helping their clients meet the transfer pricing compliance standards adopted in many jurisdictions.[217]

V. OECD'S BEPS PROJECT

Any substantive changes in the current transfer pricing regime will require international cooperation. In January of 2013, the OECD issued its BEPS report[218] and followed up in July 2013 with an Action Plan that identified specific weaknesses in international taxation, made general proposals to address those weaknesses, and set an ambitious timeline to complete those goals.[219] In 2015, the OECD published the results of the Action Plan in a series of final reports.[220]

[215] *Id.*
[216] OECD, *Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (2014), http://www.oecd.org/ctp/transfer-pricing/discussion-draft-transfer-pricing-documentation.pdf.
[217] *See* Ernst & Young, *supra* note 121.
[218] *BEPS Report*, *supra* note 6.
[219] *Action Plan*, *supra* note 9.
[220] *See, e.g.*, *Final Report on Transfer Pricing*, *supra* note 10.

A. *The Action Plan and The Final Reports*

The Action Plan acknowledged that enforcement of the arm's-length standard was a major issue and, in some cases, MNEs have been able to "use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it to low-tax environments."[221] The shortfalls of the arm's-length standard that result from transfer pricing abuse are the transfer of intangibles and other mobile assets for less than fair market value, the over-capitalization of related entities in low-tax jurisdictions, and contractual allocation of risk to related entities in low-tax jurisdictions in transactions that would not normally occur between unrelated parties.[222]

In order to eliminate transfer pricing abuse, the report provided four separate Actions--Nos. 8, 9, 10, and 13.[223] Action 8 proposed to develop rules to prevent BEPS by moving intangibles among group members, which involved the following actions: adopting a broad and clear definition of intangibles, ensuring that profits associated with the transfer and use of an intangible are allocated according to its value creation, developing transfer pricing rules or special measures for hard to value intangibles, and updating the guidance on cost-sharing arrangements.[224] The Final Report regarding Action 8 provided new versions of Chapter VI (Intangibles) and VIII (Cost Contribution Arrangements) of the OECD Transfer Pricing Guidelines and a specific transfer pricing approach to hard-to-value intangibles, [225] which have been incorporated by amendment into the OECD Transfer Pricing Guidelines (Guideline Amendments).[226] Notably, the OECD finalized its changes to Chapter VI of the OECD Transfer Pricing Guidelines on intangibles except for Part D, pertaining to the application of the profit split method of pricing intangibles.[227]

The OECD issued a discussion draft on the use of profit splits in December 16, 2014 (2014 Discussion Draft), suggesting a pendulum swing in favor of source-country taxation as the concepts of "integration" and "global value chains" seemed to make it easier for tax administrations

---

[221] *Action Plan*, *supra* note 9, at 19.
[222] *Id*. at 20.
[223] *Id*.
[224] *Id*. at 22.
[225] *Final Report on Transfer Pricing*, *supra* note 10, at 63-141, 161-183.
[226] OECD, *OECD Council approves incorporation of BEPS amendments into the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (June 15, 2016), *available at* http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm [hereinafter "*Guideline Amendments*"].
[227] *Final Report on Transfer Pricing*, supra note 10, at 103-04.

to apply profit split methods as a default.[228] The 2014 Discussion Draft went further, subtly directing the focus of the discussion draft to the subject of formulary apportionment.[229] In response to the criticism of the 2014 Discussion Draft, the OECD issued draft guidance on profit split methods on July 4, 2016 (2016 Discussion Draft), which states that the use of profit splits would be confined to situations in which the parties share in "economically significant risks," and they would not be appropriate for entities with a level of operational integration typical for associated enterprises.[230]

Action No. 9 proposed to develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members by preventing over-capitalization and/or contractual transfer of risk through transfer pricing rules or special measures.[231] The Final Report for Action No. 9 led to significant revisions of Chapter 1, Part D. of the OECD Transfer Pricing Guidelines (Guidance for Applying the Arm's Length Principle), adding risk as an integral part of a functional analysis, providing a six-step framework on how to analyze risk, and limiting capital-rich MNE group members that only provide funding without any other relevant economic activities, i.e., a "cash box," to a risk-free return.[232] These revisions were also incorporated through the Guideline Amendments.[233]

Action No. 10 proposed to develop transfer pricing rules or special measures to clarify when a transaction will be re-characterized and sought to clarify when to apply the profit split method in the context of global value chains.[234] Action No. 10 also expressed a need to protect against common types of base eroding payments.[235] In addition to the revisions for Chapter 1, Part D, of the OECD Transfer Pricing Guidelines, the Final Report's result for Action No. 10 led to a rewrite of Chapter 7 of the OECD Transfer Pricing Guidelines (Special Considerations for Intra-

---

[228] OECD, *BEPS Action: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains* (2014), *available at* https://www.oecd.org/tax/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf. *See also* Kevin A. Bell, *No Formulary Element in Latest OECD Draft on Profits Splits*, 25 TAX MGM'T TRANSFER PRICING REP. 343 (July 14, 2016).

[229] Nicola Lostumbo, Ryan Decker, Richard Dadzie, & Andrew Dust, Pricewaterhousecoopers, LLP, *Profit Splits Post-BEPS: Quantifying an MNE's Intangibles*, 80 TAX NOTES INT'L 707 (Nov. 23, 2015). *See also* Mindy Herzfeld, Tax Analysts, *News Analysis: Will the OECD's 'Pragmatic Fudge' Save Transfer Pricing?*, 2016 WTD 147-1 (Aug. 1, 2016) (acknowledging practitioner fears stemming from the 2014 Discussion Draft which suggested a creeping approach toward formulary apportionment).

[230] OECD, *Public Discussion Draft-Revised Guidance on Profit Splits* (2016), *available at* http://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf.

[231] *Action Plan*, *supra* note 9, at 22.

[232] *Final Report on Transfer Pricing*, *supra* note 10, at 13-47.

[233] *Guideline Amendments*, *supra* note 226.

[234] *Action Plan*, *supra* note 9,o at 20-21.

[235] *Id*.

Group Services),[236] which was incorporated through the Guideline Amendments.[237] Once again, the OECD left the door open on rules or special measures on the application of the profit split method, with the most recent work reflected in the 2016 Discussion Draft.[238]

B. *Subtly Departing from the Arm's-Length Standard*

Despite the OECD's outward affirmation of the arm's-length standard, the OECD has laid the foundation to move on from the arm's-length standard. As noted at the beginning of this paper, the OECD responded to critics of the current transfer pricing regime by stating, "rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system . . . [n]evertheless, special measures, either within or beyond the arms-length principal, may be required . . . ."[239] This constant reference to special measures allows flexibility for methods outside of the arm's-length standard. In addition, the OECD demonstrated the direction it sought to take in its 2014 Discussion Draft, laying the foundation for greater use of profit spit methods (though it backed down after great pressure in the 2016 Discussion Draft).[240] Even though profit split methods are deemed to be arm's-length methods,[241] they are more akin to formulary apportionment because they allocate combined operating profits of controlled transactions by a formula based on the relative value of each taxpayer's contribution.[242]

The OECD also identified asymmetry of information between taxpayers and tax administrators as a key issue in impeding effective administration of the transfer pricing rules.[243] Particularly, the Action Plan notes that tax administrators lack adequate information to have a big picture of a MNE's global value chain,[244] and divergences in transfer pricing documentation requirements between various nations significantly increase the administrative costs for MNEs.[245] The results of the Final Report on Transfer Pricing for the controversial Action No. 13 addressed this asymmetry, setting forth standards for transfer pricing documentation and a template for CbC reporting of income, taxes paid and certain measures of economic activity,[246] both of which are now incorporated in the OECD Transfer Pricing Guidelines through the Guideline

[236] *Final Report on Transfer Pricing*, *supra* note 10, at 141-53.
[237] *Guideline Amendments*, *supra* note 226.
[238] *Final Report on Transfer Pricing*, *supra* note 10, at 55-62.
[239] *Action Plan*, *supra* note 9, at 20.
[240] *See supra* text accompanying notes 228-30.
[241] *See*, *e.g.*, Gianni, *supra* note 80, at 175.
[242] Bell, *supra* note 228 (noting that critics of the profit split method consider it to resemble a formulary method, which contradicts the internationally accepted arm's-length standard for transfer pricing).
[243] *Action Plan*, *supra* note 9, at 22-23.
[244] *Id.*
[245] *Id.*
[246] *Final CbC Report*, *supra* note 176.

Amendments.[247] The revised transfer pricing documentation standards and the template for CbC reporting entail a three-tiered approach which consists of: a "master file" that provides tax administrations with high-level information regarding MNEs' global business operations and transfer pricing policies; a specific "local file" that provides a local tax administration with information regarding material related party transactions, the amounts involved, and the company's analysis of the transfer pricing determinations they have made with regard to those transactions; and a CbC reporting template that includes information on revenue (related and unrelated party), profits, income tax paid and taxes accrued, employees, stated capital and retained earnings, and tangible assets for each tax jurisdiction in which the MNE does business.[248] In addition, the template includes information identifying each entity within the MNE group doing business in a particular tax jurisdiction and the business activities each entity conducts.[249] Thus, the OECD fulfilled the commission it received from the G-8 in the Lough Erne Declaration while further showing its willingness to move away from the arm's-length standard by providing the tools necessary to implement formulary apportionment.[250]

The BEPS project has created a backlash among tax professionals and the Treasury Department. Robert Stack, former Treasury Deputy Assistant Secretary (international affairs), stated that the United States is "extremely disappointed in the output" of the BEPS project.[251] Ernst and Young urged development of alternative tax transparent reporting approaches in order to stem the tide against CbC reporting.[252] The Institute of Chartered Accountants of England and Wales, as well as Deloitte, expressed concern of risks inherent in CbC reporting.[253] All were opposed to factors that would facilitate the use of a formula to allocate income over the current arm's-length standard.[254]

Fierce opposition has stopped any substantial reform in transfer pricing in the OECD BEPS project, as seen in the OECD's adherence to the arm's-length standard and the watered-down final version of the CbC reporting requirement, which only requires reporting from MNEs with gross receipts higher than €750 million and subjects the reporting to confidentiality and appropriate use protections by the home-country tax authorities collecting the information before it can be shared with others.[255] If the OECD really wants to address BEPS and transfer pricing

---

[247] *Guideline Amendments*, *supra* note 226.
[248] *Final CbC Report*, *supra* note 176.
[249] *Id*.
[250] G8, *supra* note 94.
[251] Jeremy Scott, *U.S. Blasts BEPS Project*, 47 TAX NOTES 1213 (Jun. 15, 2015).
[252] Murphy, *supra* note 43.
[253] *Id*.
[254] *Id*.
[255] Sol Picciotto, *Taxing Multinational Enterprises as Unitary Entities*, 82 TAX NOTES INT'L 895 (May 30, 2016).

abuse, the OECD will need to take a bolder stance and adopt a form of formulary apportionment in lieu of the arm's-length standard.

CONCLUSION

Effective transfer pricing enforcement in a regime based on the arm's-length standard is truly dead. Though the original estimates of its effect may have been overestimated, BEPS is still a major issue, and transfer pricing abuse has become the favored mode of tax avoidance because of the arm's-length standard's inadequacy in valuing intangibles. There has always been a fundamental flaw in assuming that there is an arm's-length price for intercompany transactions within a MNE, especially when there are no comparables. Exploiting the fundamental flaws of the arm's-length standard has created reactionary, complicated tax administrations that are ineffective and impose huge administrative and compliance burdens on both administrators and taxpayers. Regardless, tax professionals still advocate for maintaining the current transfer pricing regime because of the opportunities to serve clients through tax planning and compliance.

Although the arm's-length standard has been in the political hot seat before, never has there been such strong political will across the globe to combat BEPS. The OECD has taken some steps, but in order to address the flaws of the arm's-length standard, the OECD needs to take a bolder stance. It is time to abandon the arm's-length standard and embrace a system of formulary apportionment. This change would address many of the flaws of the arm's-length standard, which would in turn eliminate much of the administrative and compliance burdens for tax administrators and taxpayers and provide a mechanism to combat BEPS more effectively.