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EVOLUTION OF THE ARM'S LENGTH STANDARD IN THE US TRANSFER PRICING LEGISLATION AND RUSSIAN ARM'S LENGTH PERSPECTIVE

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by

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B.A., The Moscow State University School of Law, Russia, 1996

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CHAPTER I. INTRODUCTION

"Taxation is this area is an art, and no amount of complex methodology can turn it into an exact science"¹.

1. Transfer Pricing Defined

In the face of the process of internalization of the business and economic activities worldwide, the issues relating to international trade and investment become more and more important. One of the most complex and complicated issues of taxation of international operations of corporations is the taxation of the income from transactions involving the transfer of price.

Pricing is a mechanism by which a seller comes with a buyer to an agreement to transfer goods and services. Whether the buyer and seller are related parties is a matter of great importance because this issue may have a direct and tremendous impact on the formation of the price at which the goods or services are sold or provided. When the transfer of goods or services is exercised between unrelated buyers and sellers, the price of the goods or services is deemed to be a fair market price, i.e. the price solely determined by the market, rather than by fact that the parties are related. This makes a perfect logical sense, because the parties entering into commercial deals presumably have

¹ JILL C. PAGAN, J. SCOTT WILKIE, TRANSFER PRICING STRATEGY IN A GLOBAL ECONOMY, 16 (IBFD Publications 1993).
a profit as their ultimate motive. However, whenever anything of value, be it goods or services, is transferred between parties that are members of the same group, or are related through cross-ownership structure, the picture is different, because both the transferor and the transferee are controlled by the same party in interest, and the price in such a transaction is not necessarily affected by the market conditions. If to draw the simplest analogy, the related party transaction means the transfer of cash from one pocket of the coat into another, which does not make any difference to the owner of this coat.

Transfer pricing is a concept, which refers to the establishing of prices in transactions structured in a specific way between related parties. Structuring of transactions by means of the transfer of price between related parties may produce dramatically favorable tax results. To prevent this tax avoidance effect, the notion of the arm’s length price was introduced and accepted as a principle of dealing with transfer pricing issues.

2. Scope and Organization of the Thesis

This thesis analyzes the evolution of the arm’s length standard (ALS) as the key element of the transfer pricing control system in the US. This thesis also addresses some issues on creation of transfer pricing legislation in the Russian Federation and focuses on three sets of problems. First, it provides the general outline of the legislative history of the ALS as well as the history of the ALS’ application in the US, including overview of landmark cases, which revealed some conceptual problems with respect to the ALS.

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Secondly, the thesis addresses core problems associated with the ALS, such as inability of the ALS to cope with the taxation of income in the absence of comparable transactions, difficulties of the application of the ALS with respect to e-commerce issues and problems of tax base allocation in cases involving multiple tax jurisdictions. The analysis of the place of the ALS in the modern tax legislation is also made from the angle of what alternative approaches can be plausibly applied instead of the ALS.

Finally, the thesis explores the set of problems with regard to the development of the ALS in the emerging transfer pricing legislation of Russia, where the potential impact of the US transfer pricing rules and international trends should not be overlooked. This part of the thesis is not a comparative analysis, but rather an attempt to find out which parallels may be drawn and which lessons may be learned from the evolution of the ALS in the US in order to determine how the Russian legislature may finally address the ALS in Russia and to what extent it shall be developed.
CHAPTER II. EVOLUTION OF THE ARM'S LENGTH STANDARD IN THE US

1. How the Arm's Length Standard Works

a) Freedom to Structure Business Transaction

Typically, transfer pricing issues arise in parent-subsidiary and brother-sister sales setting. However, if a business is organized internationally, transfer pricing may affect almost every step in the process of the production.

Why did prevention of a conceptually simple transfer of price result in the enormous body of tax laws and regulations? Why does it draw such a close attention? The obvious answer is because the international business is surrounded by so many variables, that the law, in order to regulate all the uncertainties arising out of the practical application of transfer pricing rules, has to develop mechanisms, which would prevent a misuse of evident and possible loopholes by taxpayers.

As it was stated above, transfer pricing is a concept, which refers to the formation of prices in transactions structured in a specific way between related parties. It is well established, at least in the US, that a taxpayer is entitled to structure his affairs and transactions in order to minimize his taxes. In Helvering v. Gregory judge Learned Hand wrote, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a

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3 Transfer pricing problems may include some domestic non-tax issues, like corporate law. For example, minority shareholders cannot prevent the corporation where they have no controlling interest from entering in a transfer pricing transaction with another corporation, also owned by the controlling interest. See C. H. Gustafson et.al, TAXATION OF INTERNATIONAL TRANSACTIONS, MATERIALS TEXTS AND PROBLEMS, 500 (West Group 1997).

patriotic duty to increase one's taxes."\(^5\) When several affiliated companies are engaged in the process of production and sale, it is possible for the owners or controlling shareholders who control the group to structure corporate transactions of affiliates in the manner they find necessary or advantageous from a tax standpoint. Owners may manipulate prices in the transaction between the companies of the group by means of shifting profits among the group-members in order to relieve tax burden. Freedom to structure transactions coupled with tax planning produce favorable tax results for the taxpayers.

However, the taxpayers must not be excessively enthusiastic about their freedom to structure transactions. A freedom to structure does not give a taxpayer a *carte blanche* to set up a transaction exclusively for the avoidance of tax consequences. To prevent intragroup transfers of price the arm’s length standard, sometimes referred to as the independent enterprise standard, was employed to serve as a measure of the transfer pricing transaction. All major tax jurisdictions, including the US, follow the principle that transfer of prices between affiliated companies must not contradict the “arm’s length price”. That means that to be a valid intragroup transaction, a transaction must be at a price that would have been established in the open market between independent parties.

b) Definitions of the Arm’s Length Standard

Surprisingly enough, one can find definitions of arm’s length transaction, arm’s length prices or arm’s length result, but no precise definition of the arm’s length standard itself. Theoretically, the notion of the ALS is a requirement for a reference to comparable transaction. Black’s Law dictionary defines arm’s length transaction as “a transaction

\(^5\) *Id.*
negotiated by unrelated parties, each acting in his or her own interest; the basis for a fair market value determination. It is a transaction in good faith in ordinary course of business by parties with interdependent interests." The most extensive descriptive definition of the ALS was made by the US Treasury in Regulation 1.482-1(b): "A controlled transaction meets the arm’s length standard if the results of that transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the circumstances (arm’s length result). However, because identical transactions can rarely be located, whether a transaction produces an arm’s length result generally will be determined by reference to the results of comparable transactions under comparable circumstances". The ALS was also endorsed by the Organization for Economic Cooperation and Development Committee (OECD) as a standard being used for tax purposes by the OECD member countries tax authorities and multinational enterprises. The OECD introduced the definition of arm’s length prices as “prices, which would have been agreed upon unrelated parties engaged in the same or similar transactions under the same or similar conditions in the open market”.

c) Mechanism of Application

i) Section 482 of the U.S. Tax Code. The source of the US transfer pricing provisions is contained in the section 482 of the Internal Revenue Code (IRC). The provision consists only of two sentences: “In any case of two or more organizations,
trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property... the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible".11 The provision of section 482 is accompanied in the detailed Regulations, which define the terminology, explain the mechanism of application of the general rule and provide for special rules.

ii) How mechanism works. Basically, the ALS is used to determine how to allocate the income among related companies. As it can be seen from the dry language of the act, the mechanism for application of the transfer pricing rules is based on comparison of transactions. If the income of taxpayer is distorted by the manipulations with prices, it must be adjusted under section 482 to reflect the “true” picture of the transaction entered into by a taxpayer. The applicable standard for the purposes of adjustment is the ALS. The comparison of controlled and uncontrolled commercial transactions is a complex thing, where different factors shall be taken into account. The factors of comparability are listed in the Reg. 1.482–1(d) and include the following: functional analysis of activities of the parties, contractual terms, risks undertaken, economic conditions of the industries and relevant markets, and nature of property or

services\textsuperscript{12}. The Regulations also provide guidelines for the selection of the most appropriate method for the comparison of sales. In case of sale of tangible property the Commissioner is entitled to apply one of the six allocation methods; if sales of intangibles occurred- four allocation methods prescribed by the Regulations. The general purpose of the above mechanism is to create a tax parity between a controlled and independent taxpayers by means of determining the true taxable income of the controlled taxpayer.\textsuperscript{13}

2. Short Legislative History of the Arm’s Length Standard

a) Development of the MNEs around the world.

As practice shows, most frequently, the ALS analysis is invoked in the context of taxation of the multinational enterprises (MNEs) conducting their operations throughout the world, therefore the evolution of the MNEs may be regarded as an integral part of the evolution of the ALS.

International trade has existed for ages, but first multinational enterprises can be traced back to the 16th-17th centuries. Among the most well-known were the Dutch East India Company (est. 1605), the Hudson Bay Company (est. 1670), the East India Company (est. 1698)\textsuperscript{14}. Truly multinational corporations were formed in the second half of 19\textsuperscript{th} century, when development of technologies and management process allowed corporations to diversify production process across the world. At that period in Europe some big British and German companies undertook their first foreign investments. The

\textsuperscript{11} I.R.C., section 482.
\textsuperscript{12} Treas. Reg. section 1.482-1(d) (1994).
\textsuperscript{13} Treas. Reg. section 1.482-1(a) (1994).
\textsuperscript{14} See JILL C. PAGAN, J SCOTT WILKIE, TRANSFER PRICING STRATEGY IN A GLOBAL ECONOMY 22 (IBFD Publications 1993).
list of famous names includes Lever Brothers, Dunlop, Ciba, BASF, Bayer, Siemens and a number of others\textsuperscript{15}. In the same period American MNEs began to grow. The trend is exemplified by the American Singer Sewing Machine Company which was one of the first to reject export sales in favor of the manufacturing its product overseas to supply growing foreign markets\textsuperscript{16}.

The period after the Second World War was characterized by the dominance of the US companies in the world economy. Gradually, European companies recovered from the consequences of the war and started to rebuild their international networks. In the 1960s, Japan emerged as a major foreign investor. The second half of the 20\textsuperscript{th} century was a period of a renewed competition between the MNEs as well as period of their constant development. The pattern of the development is export sales and direct investments. Another reason to transfer operations abroad was high taxes in a home country, which almost always was the case for the US companies. Multinationals exported their production and distributed it through their affiliates, until affiliates grew out of this role and started to accept responsibility for the manufacturing of product at the local markets, thus becoming research and production centers themselves. The result of this process that we face nowadays is a “global assembly line” and highly integrated international business worldwide.

b) US Acts and Regulations 1917-1968

i) Early development. In the US, issues relating to transfer pricing were first addressed at the time of the World War I. The Governments of the belligerent nations

\begin{footnotesize}
\begin{enumerate}
\item P. Muchinski, MULTINATIONAL ENTERPRISES AND THE LAW 21 (Blackwell 1995).
\item Id.
\end{enumerate}
\end{footnotesize}
were anxious to discourage tax avoidance by the MNEs by means of the transfer of prices
to their affiliates abroad away from the high-tax jurisdictions. The early transfer pricing
legislation was of a general anti-avoidance character. In 1917, the US introduced the War
Revenue Act, providing for the necessity to determine equitably the taxable income. It
was followed by the regulation issued by the Commissioner of the Internal Revenue,
which provided for the requirement for affiliated corporations to file consolidated tax
returns as an anti-tax avoidance device. Revenue Act of 1921 introduced income tax
allocation mechanisms. The Act withdrew the authority of the Commissioner to
consolidate tax returns of the affiliated companies, but authorized the Commissioner to
consolidate the accounts of the related trades or businesses for the purpose of making
apportionment of tax.

In 1928, the consolidated accounts provisions were eliminated. Instead, section 45
“Allocation of Income and Deductions” was introduced, which contained the original
version of the modern section 482: “In any case of two or more trades or businesses
(whether or not incorporated, whether or not organized in the United States, and whether
or not affiliated) owned or controlled directly or indirectly by the same interests, the
Commissioner is authorized to distribute, apportion, or allocate gross income or
deductions between or among such trades or businesses, if he determines that such
distribution, apportionment or allocation is necessary in order to prevent evasion of taxes
or clearly to reflect the income of any of such trades or businesses”. Section 45 was a
predecessor of section 482. Although it provided for the mechanism of control, the
standard applicable was not stated.
ii) 1930s-1950s. *Introduction of the arm’s length standard.* The arm’s length standard itself was first introduced in 1934 by one the earliest US regulations under section 45 of the Internal Revenue Code.\(^{20}\) It stated: “The scope 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...The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm’s length with another uncontrolled taxpayer.”\(^{21}\) Thus, the ALS became a major principle when dealing with transfer pricing issues. During the Second World War and shortly after it there was little change into the transfer pricing legislation. In 1954 section 482 appeared, but it borrowed the provisions from section 45 without significant changes.

At this historical period, the transfer pricing issues arose in the context of domestic tax evasion issues, like shifting of income from one domestic entity to another or using a group of entities for exemption treatment.\(^{22}\)

iii) *Development in the 1960s.* After the World War II the change in economic conditions resulted in the expansion of the American business abroad. In 1960s the US Administration showed concerns about the enormous potential of tax abuse by American companies, which used their affiliates abroad. In order to bring the transfer pricing legislation up-to date, changes to section 482 were introduced. Also subpart F of the Code was adopted which provided for the “foreign controlled corporation” rules. In 1968, Regulations 1.482 were introduced, which remain generally unchanged until today. The regulations stated again that the ALS was the cornerstone of the US transfer pricing

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\(^{19}\) Revenue Act of 1928, ch.852, s.45, 45 Stat. 806 (1928).


\(^{21}\) Reg. 86 (1935) (Revenue Act of 1934), Art. 45-1(c).
legislation. However, at this period of time the Congress considered also the idea of using a formula to allocate income between related parties as an alternative method for prevention of the transfer pricing abuse. The 1968 regulations provided for adjustments, established the rules for transaction on sale of tangible goods, intangibles and performance of services. It provided for the use of three methods for the purpose of establishing transfer prices for tangible and intangible property. For the transfers of intangible property the regulations required the use of comparable uncontrolled transaction. If uncontrollable transaction was not available, twelve special factors in order to establish the arm’s length rate may be considered. The priority in which methods should be applied was mandatory. The 1968 regulations were criticized heavily for the administrative burdens and practical difficulties they posed both for the IRS and taxpayers, which resulted in their subsequent revision.

Shortly before the adoption of 1968 Regulations the US began an international campaign to convince the other countries to adopt a US-like transfer pricing rules. The US stated that a unilateral approach in adopting the ALS is not sufficient for its successful application and declared that it was seeking a worldwide acceptance of this standard23.

c) Recent Development.

i) Tax Reform Act 1986. Focus on Intangibles. In the middle of 1980s, the Congress again expressed concerns about increasingly developing manipulations of

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22 See supra note 20 at 2.02[8]
prices by the MNEs. The most serious transfer pricing problems involved intellectual property transactions. As case law in 1970s demonstrated, the transfer of intangible property between related companies created the majority of practical difficulties in the application of the ALS. US corporations started to transfer high-profit intangibles to their foreign controlled corporations for low royalties, which allowed MNEs in a situation where the use of intangibles abroad was very beneficial, to shift taxation of income produced by such assets, to foreign jurisdictions with tax rates lower than in the US. In the absence of the adequate provision for adjustment, transfer of intangibles at less than their true value became a well-established practice.

Moreover, on the top of such wide-spread practices, the IRS faced practical difficulties in determining whether the arm’s length transfers between unrelated parties are comparable. All that gave rise to ideas that payments made on a transfer of intangibles to a related companies abroad should be proportionate to the economic value of this intangible property. These ideas were implemented in the Tax Reform Act of 1986, which added a new provision to Section 482, often referred to by commentators as “super-royalty” provision, which stated that in case of any transfer of intangible property to a related party abroad, the income with respect to such transfer shall be commensurate with the income attributable to the intangible.

ii) 1988 White Paper. Creation of the reliable mechanism of taxation of income from intangibles remained one of the priorities for the IRS. In 1988 the US Treasury and the IRS released “A Study of Intercompany Pricing”\(^{24}\). This document is often referred to as the 1988 White Paper. It contained interpretation of the 1986 amendments to Section
482 and introduced several different approaches to the allocation of income from a transfer of intangibles. Generally, all these approaches were directed at ascertaining price as close as possible to an arm’s length price. The White Paper focused on the methods based on the income generated by the intangibles rather than on the comparability of transactions. “The White Paper of 1988 represents a significant attempt to tackle the inherent weakness of the arm’s length approach, in particular, the assumption that comparable sales between uncontrolled entities exist from which an arm’s length price can be determined”\textsuperscript{25}.

iii) Attempt to abandon ALS. The 1992 Proposed Regulations and 1993 Temporary Regulations. The 1992 and 1993 regulations were important milestones in the development of the ALS. The regulations dealt with transfers of both tangible and intangible property and proposed pricing methods based on the comparison of profits, which were not considered as “traditional” arm’s length methods. The proposed regulations caused debates in the US and in the business world outside the US. The approach to transfer pricing transaction proposed by 1992 regulations was met with criticism.

Some authors noted that the proposed regulations could be characterized as an abandonment of the ALS.\textsuperscript{26} Some of the US trading partners believed that the methods, which focus not on the profit from the particular transaction between independent parties but on profits from larger business categories were not quite consistent with the ALS\textsuperscript{27}. It

\textsuperscript{25} MUCHLINSKY, supra note 15 at 292.
\textsuperscript{26} ROGER Y.W.TANG, INTRAFAIRM TRADE AND GLOBAL TRANSFER PRICING REGULATIONS 70 (Quorum Books, 1997).
\textsuperscript{27} Lepard, supra note 23 at 52
was also noted that regulations adopted some rules that were problematic and sometimes unrealistic. "The proposed regulations were found to be unacceptable by nearly everyone but the drafters, inspiring negative commentary from taxpayers, practitioners, and foreign governments."\textsuperscript{28}

In line with this criticism, the IRS decided to change the focal point of its strategy. In 1993 the Treasury issued new regulations under section 482, which were more consistent with respect to the methodology. An important innovation of the 1993 regulations was the "best method" rule, a rule for selecting a right pricing method to be applied, which eliminated the mandatory priority of methods to be used. According to the idea of the IRS, the best method would be "the most accurate measure of an arm's length result"\textsuperscript{29}.

Generally, the reaction to the 1993 temporary regulations was favorable. The critique came from the International Chamber of Commerce (ICC) Commission on Taxation. The ICC Commission concluded that the ALS was the only legitimate approach in dealing with the transfer pricing transaction, and that the 1993 Regulations attach too much weight to some "non-traditional" methods, like comparison of profits. The Commission argued that 1993 regulations are open to the same objections on grounds of impracticality as well as on grounds of incompatibility with the ALS\textsuperscript{29}.

\textit{iv) The final Regulations of Section 482.} The final regulations of section 482 were issued in 1994. Despite the fact that they replaced 1993 temporary regulations, they are consistent with the 1993 version. Three basic standards are required to apply when dealing with transfer pricing transaction: 1) the ALS; 2) the best method rule; 3)

\textsuperscript{28} Tang, \textit{supra} note 26 at 70.

\textsuperscript{29} Tres. Reg. 1.482-5T(a), paragraph 27.
comparability analysis. The final regulations provides for six methods for the transfers of tangible property and four methods for intangibles. Generally, the same principles and methods apply to the pricing of services. More detailed analysis of the provisions of final regulations is made in connection with the analysis of impact of the judicial practice on the modern legislative development.

d) The OECD Contribution.

The OECD takes an active part in the development of the principles of international taxation in the modern world. Many OECD member states adopted the OECD guidelines for transfer pricing, which enabled them to achieve consistency in application of their national transfer pricing legislation and to avoid economic double taxation of the MNEs. It is appropriate to consider the OECD regulations on the ALS within the framework of the question of the US transfer pricing regulations because the US is an active member of the OECD and was a major promoter of the adoption and promulgation of ALS by the OECD.

Bilateral treaties are the primary mechanism for resolving disputes between OECD member countries, arising out of application of international tax rules. In 1963, the OECD issued the Model Tax Convention on Income and Capital, which contained the proposed language for bilateral treaties. Article 9 of the Model Convention prescribed to apply arm’s length principle in cross-border transfer pricing. It is provided in the Article 9 that tax authorities of contracting states shall consult each other on making appropriate transfer pricing adjustments, and where one country makes a transfer pricing adjustment,

\[\text{\cite{MUCHLINSKY, supra note 15 at 295.}}\]
the other country shall make an appropriate adjustment to the amount of tax charged. In 1977 the OECD promulgated a new model tax treaty, where Article 9 provision on adjustment was expanded.

Since late 1970s, the Committee on Fiscal Affairs, which has a jurisdiction over tax policy, presented a number of reports and guidelines on transfer pricing issues. The most important were three following reports. In 1979 the OECD issued report Transfer Pricing and Multinational Enterprises (Paris: OECD, 1979), which established a guidelines for determining arm’s length prices for business transactions between related parties. The 1984 report, Transfer Pricing and Multinational Enterprises: Three Taxation Issues (OECD, 1984) discussed adjustment and allocation of costs issues, as well as transfer pricing in multinational banking.

In 1995 Transfer Pricing Guidelines of Multinational Enterprises and Tax Administrations (Paris: OECD, 1995) superseded these reports. The 1995 report was the most comprehensive document of all the guidelines issued by the OECD with respect to transfer pricing. The 1995 guidelines covered several issues, including the application of arm’s length principle. The OECD recommends applying ALS as the most reliable standard in determining the transfer of price between related parties. Two reasons were mentioned as important for the adoption of ALS as the governing principle in transfer pricing. The ALS provides for the tax parity between affiliated and non-affiliated entities, and, also, it eliminates the risk of double taxation. “Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids creation of tax advantages and disadvantages that would otherwise distort the

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relative competitive positions of either type of entity." The guidelines also stated that application of ALS is generally based on a comparison of the conditions in controlled and uncontrolled transactions, and that ALS requires the application of just one method, not more, to compare transactions.

It is worth noting that the OECD was always committed to the ALS and was consistent in its development. In the 1970s the OECD, apparently influenced by the US, publicly advocated the ALS and rejected the alternative methods of transfer price regulation. The attempt of the US to step aside from the ALS, which was taken in the proposed 1992 section of 482 regulations (see above), was severely criticized by the OECD. In 1993, the OECD issued a special report devoted to the analysis of the proposed 1992 regulations of section 482. The report stated that “the implementation of the proposed 482 regulations in their present form could risk undermining the consensus that has been built up over a number of years on the application of the arm’s length principle and thereby increase the risk of economic double taxation”.

Some suggestions that were made in the OECD 1993 report were considered and adopted by the US tax authorities in the final regulations of section 482.

Despite some disagreements with respect to the transfer pricing methods that need to be applied for the transfers of tangible and intangible property and other minor issues, the final version of section 482 US and 1995 OECD guidelines show substantial similarity in treatment of transfer pricing transactions. This harmonization in the approaches of the US and the OECD will undoubtedly have a positive effect on the

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development of international activities of MNEs, by providing clear and uniform standard governing transfer pricing transactions.

e) Summary on the Legislative Development of the Arm’s Length Standard

The ALS was created under the US tax law and later was subsequently accepted by tax authorities throughout the world as a proper method to deal with transfer pricing transaction. During the last 10 years, transfer pricing issues related to the ALS have undergone substantial changes. Some transfer pricing researches and commentators noted that the continuous debates caused by the controversies of the introduced changes and disagreements between the interested parties in effect benefited all. “Thanks to the debates and cooperation among most transfer pricing stockholders ... all of the key transfer pricing legislation and regulations are now in a place. These regulations should provide badly needed stability and certainty in intrafirm trade and transfer pricing in the future.”34 However, not all of the researches are so enthusiastic about whether the desired stability and certainty was achieved. As some facts and conclusions below demonstrate, many questions with respect to the effectiveness of the existing transfer pricing legislation remain highly contentious.

The history shows that regulation of the transfer pricing issues are becoming increasingly complex, due largely to the ingenuity of MNEs’ tax counsel and limited only by the MNEs desire to test new transfer pricing techniques in courts. Inherent complexity of the practical issues related to transfer pricing coupled with temptations for tax minimization within MNEs and inability of the Congress and the IRS to provide a clear

34 Id. at 88.
cut standard curbing transfer pricing misuses, moved the battlefield to courtrooms, forcing courts to deal with tax planning innovations of MNEs.

3. Development of the Arm’s Length as a Standard by the Judicial Practice.

The US system of the transfer pricing control is probably the most elaborated in the world. However, even a great number of detailed rules and regulations cannot prevent disputes from arising. US tax courts, where the transfer pricing disputes are resolved, took an active part in the development of ALS. In effect, as history demonstrates, many new regulations on transfer pricing were triggered by the reaction of the Treasury and the Congress to the judgment of the certain case.

a) Generally.

In transfer pricing disputes litigation was always used as a last resort, when all other means of settling the dispute failed. Transfer pricing cases generally deal with one question – whether a transaction correctly reflects a taxpayer income. Although cases may involve a lot of issues, the attention is basically focused on the application of a standard. Because the ALS, as the applicable statutory standard, means the fair market price in the uncontrolled transaction, the application of the ALS by courts resulted mainly in the search of the comparable uncontrolled transactions.

Transfer pricing cases have some similar features. They are fact - and - circumstances oriented, their factual patterns are often similar. Taxpayers involved are almost always MNCs and their offshore-based affiliates. If the IRS determines that a
transaction was not at arm's length and the adjustment must be made, the taxpayer typically tries to demonstrate that the adjustment was arbitrary and unreasonable. The burden of proof is on the taxpayer. Judicial decisions are often very complex and lengthy. There are not very many cases on transfer pricing came to courts. Not many transfer pricing cases come to courts. Some of them, which reflect certain stages in the development of the ALS are considered below. The cases below are viewed not from the perspective which party obtained the favorable judgment but rather from the angle of the application of the ALS.

b) ALS in Judicial Decisions

i) Early cases. First transfer pricing cases did not mention the ALS but rather focused on the application and meaning of statutory terms, such as “tax evasion”. Only after the introduction of the ALS in 1934 regulations, the courts shifted focus to the application of this standard. However, in search of the comparable transactions that would reflect the real taxpayer’s income in a most precise way the courts apply variety of standards.

The early cases seem not to be very consistent with the application of the ALS, which was not in the statute. One of the first early cases, the Seminole Flavor Co v. Commissioner was decided in 1945. Deciding a question whether transactions between a corporation and a partnership organized to distribute the corporation’s products should be adjusted and whether the income of the partnership should be attributed to the corporation, the Tax Court reduced the application of the ALS to the question whether transaction was “fair and reasonable”. The court decided that it was not necessary to
search for the comparable transaction or to determine whether unrelated parties would have entered into the similar agreement.

This line of reasoning seemed to be a common feature of the early cases with respect to transfer pricing disputes. Judicial practice tended to ignore the question of whether the comparable transaction existed, and, instead, apply a variety of standards based on the vaguely defined notions "fairness", "reasonableness" or "full value". The question whether ALS should always be applied was raised in 1962 in *Frank v International Canadian Corporation*.

Interestingly enough, the issue was raised some twenty seven years after the ALS was introduced in the regulations. The IRS lost this case in the District court and appealed, stating that the court erroneously applied some "reasonable return standard" instead of the prescribed by the regulations arm's length standard.

However, the Court of Appeal for the Ninth Circuit affirmed. "We do not agree with the Commissioner's contention that "arm's length bargaining" is the sole criterion for applying the statutory language of section 45 in determining what the "true net income" is of each controlled taxpayer. Many decisions have been reached under section 45 without reference to the phrase "arm's length standard" and without reference to Treasury Department Regulations and Rulings, which state the talismanic combination of words- "arm's length" in the standard to be applied in every case. For example, it was not any less proper for the District court to use here "reasonable return" standard then it was for other courts to use "full fair value", "fair price including a reasonable profit", "method which seems not unreasonable", "fair consideration which reflects arm's length

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35 4 T.C. 1215 (1945)
36 308 F.2d 520 (9th Cir.1962)
dealing”, “fair and reasonable” or “fair and fairly arrived at”, or “judged as to fairness”, all used in interpreting section 45”. The fact that the Ninth Circuit questioned the necessity to apply the ALS exclusively by looking for comparables opened the door for the courts to “innovative” finding of possible standards.

Such a loose treatment of the language of regulations probably was not to the IRS’ liking. Besides, in the beginning of 1960s, the MNEs increased their activities in shifting profits to their offshore affiliates by using more sophisticated tax avoidance schemes. To prevent the potential of tax abuse the Treasury and the Congress drew the attention of the courts back to the narrow application of the ALS.

ii) Subsequent development. Efforts of the authorities were not without success, or, possibly, the perception of the tax avoidance activities of MNEs by the courts has changed. In 1966 the Ninth Circuit overruled Frank in Oil Base, Inc. v. Commissioner\(^\text{37}\). The case involved a commissions paid by a US corporation to its distributing foreign affiliate in the amount twice the commissions to unrelated distributors in other countries. The taxpayer argued that the ALS should not apply and that under Frank, the commissions were “reasonable”. The Tax Court disagreed and applied the ALS. The taxpayer appealed, citing Frank and arguing that ALS was applied wrongly.

However, the Ninth Circuit stepped back from the position taken in Frank and stated: “Frank v. International Canadian Corporation did not hold that the arm’s length standard established by the regulation was improper. It held that it was not the “sole criterion” for determining the true net income of each controlled taxpayer. However, permissible departure from the regulation’s arm’s length standard was, under the facts of

\(^{37}\) Frank, 308 F.2d at 528-529

\(^{38}\) Oil Base, Inc v. Commissioner 362 F.2d 212 (9th Cir. 1966)
that case, very narrowly limited and the holding has no application to the facts before us. We conclude that the arm’s length standard was properly applied pursuant to the regulation.”

Some authors believe that it is difficult to reconcile this opinion with the opinion in *Frank*, where, given the list of standards mentioned by the Ninth Circuit, the ALS role was reduced to a minimum. “In effect, the Ninth Circuit overruled *Frank*, holding that the ALS must be applied not only when comparables exist, but also when they do not exist, as the court can “hypothesize” a comparable. This abrupt reversal was likely influenced by the egregious facts of *Oil Base* and by the difficulties in applying a “reasonableness” standard”40. Although *Oil Base* was followed by the range of cases, in which courts applied the arm’s length price as the most appropriate method in determining the controlled taxpayer true income, it was not yet a breakthrough with respect to the uniform application of the ALS. Nevertheless, the ALS started to take more and more important place in court decisions, how it was intended by the statute and regulations.

**iii) Period of favorable treatment.** A number of cases decided in 1970s confirmed that the ALS was finally recognized as a standard, which must be applied to all section 482 cases41. In some cases courts applied the ALS even against the position of the IRS, which argued for the application of another standard. One of such cases is *PPG Industries, Inc. v. Commissioner*42. Some practitioners mentioned this case as the one of the first critical cases, which has continuing significance. “*PPG Industries* is a seminal

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39 *Id.* at 214
41 *e.g.* United States Gypsum *v.* United States, 452 F.2d 445 (7th Cir.1971).
case in the context of evaluating the pricing methodology used by a US-based manufacturer and its foreign sales subsidiary... In many respects *PPG Industries* can be viewed as a guide for how to create and organize an offshore affiliate, as well as how to organize and present a strong transfer pricing case\(^43\).

PPG Industries was a US company engaged in the manufacturing of glass. It has a network of subsidiaries, conducting foreign operations. It decided to establish a wholly owned subsidiary in Switzerland, which intended to be a multipurpose company. PPG and its Swiss subsidiary had basic agreements, which established rights and duties and covered many business matters, including prices and discounts. The subsidiary conducted international sales and marketing activities, including contract negotiations, marketing research, and technical assistance. It was also actively engaged in managing PPG's investments abroad. The IRS allocated the part of the income of the subsidiary to PPG Industries and asserted a deficiency. The IRS determined the deficiency on the basis of the data from the Source Book of Statistics of Income\(^44\). Probably the idea behind this was to find some data comparable to the transactions scrutinized. However, the tax authorities did not refer to the ALS to support the deficiency. At trial the IRS asserted different theories to support its position, but the Tax court found that the allocation based upon the Source Book of Statistics of Income was arbitrary and unreasonable, and did not meet the ALS. The court also held that the PPG Industries presented enough evidence that most of its prices were based on the arm's length prices, and that the "innovative" standards of the IRS were not appropriate. This case is a good example that in the 1970s

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\(^43\) *Supra* note 20 at 2.03.

\(^44\) PPG, *supra* note 42.
the courts became more stuck to the ALS, even if sometimes it was against the position of the tax authorities.

c) Shortcomings of the ALS as a Standard Revealed by Judicial Practice

In the period between 1970s and 1990s the courts and the tax authorities encountered some serious practical difficulties in applying the ALS. After some decisions, mentioned below, it became apparent that the ALS, firmly established and unquestioned until that moment, did not work in a large number of cases. The four cases below, which are widely referred to as the landmark cases\(^4\), illustrate that the application of the ALS can be problematic or can even lead astray.

One of the first sign of troubled times came in *U.S. Steel Corporation v. Commissioner*\(^5\). The case illustrates the difficulty of comparing intragroup services with the independent transaction in the circumstances where these services were somewhat unique. The taxpayer was a US based producer of steel products, which owned ore mines in the US and abroad. US Steel obtained rights to exploit a new source of iron in Venezuela and organized a US subsidiary, Orinoco, for its purpose. Later it formed a second subsidiary, Navios, to transport the ore to the United States. Navios was a Liberian corporation with a principal place of business in the Bahamas. It also rendered the transportation services to other manufacturers of steel. Navios was subject only to a 2.5% tax in Venezuela. US Steel was subject to the US tax of 48%, and Orinoco was subject to a Venezuelan tax up to 50%.

\(^4\) See *e.g.* www.transferpricing.com, see also GUSTAFSON et al, TAXATION OF INTERNATIONAL TRANSACTIONS, MATERIALS TEXTS AND PROBLEMS, 500 (West Group 1997), Section Transfer Pricing.
In this situation it was very tempting for the US Steel to shift the income from Orinoco to Navios by decreasing the selling price of the Orinoco’s ore and increasing the cost of Navios’ transportation services. Section 482 provided that in case of two or more controlled corporations the IRS can allocate income between the related corporations if such an allocation is necessary to prevent the evasion of taxes or clearly to prevent the income of any of such corporations. The IRS, having analyzed the whole scheme, decided that the prices for the transportation were increased artificially and that a part of the Navios’ income must be allocated back to the US Steel.

US Steel argued that the price it paid to Navios for the transportation was comparable to the price the unrelated steel producers paid to Navios, and, therefore, the price was set at an arm’s length, thus satisfying the IRS requirements. The Tax Court did not accept these arguments. The court held that, because no rates for transportation of ore were published in the market, the own rates of Navios could not be used as evidence. The Tax Court formulated the difficulty with respect to the application of the ALS in the following manner: “The comparability test in the regulations cannot be relied on here because the transportation of iron ore on the basis proposed by US Steel and Navios had never been done previously. There could be no “independent transactions with unrelated parties under the same or similar circumstances” within the meaning of section 1.482-1(d)(3) of the regulations”. However, in the absence of independent evidence of the arm’s length prices, the Tax Court decided that the allocation was appropriate.

On appeal the Second Circuit reversed, holding that: “We... reverse because, in our view, the Commissioner has failed to make the necessary showings that justify

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47 I.R.C., Section 482
48 US Steel, see supra note 46 at 601.
reallocation under the broad language of section 482... The “arm’s length standard ... is meant to be an objective standard that does not depend on the absence or presence of any intent on the part of the taxpayer to distort his income... We think it is clear that if a taxpayer can show that the price he paid or was charged for a service is “the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties” it has earned the right, under the Regulations, to be free from a section 482 reallocation despite other evidence tending to show that its activities have resulted in a shifting of tax liability among controlled corporations.”50 This decision underscores that any Navios transaction with any independent party was sufficient to establish the comparability. The problem with the ALS’ applicability in such situations was its complete frustration where no comparable transaction existed. Other standards were not useful, because the ALS was officially declared as the only applicable standard to all section 482 cases, which was continuously upheld by courts and the IRS itself.

Five years later the unshakeable ALS was seriously shaken by a series of “pharmaceutical” cases involving major pharmaceutical producers in the US. This time courts focused on the issue of the applicability of the ALS to intangible property transfers. This issue raised a lot of questions, which remained at this point largely unanswered. By way of introduction, the pharmaceutical industry in the US is somewhat unique because it depends greatly on research and development (R&D) expenditures to remain competitive. R&D often means patented ideas. Decisions on how to allocate R&D expenses may have a great effect on a given pharmaceutical company’s financial result

49 Id. at 602-603.
50 617 F.2d 942, 947 (2nd Cir.1980)
and profitability. Similarly, considerations of how to allocate R&D expenditures may influence U.S. corporate decisions as to whether to locate R&D operations domestically or overseas.

Chronologically, *Eli Lilly & Co v. Commissioner*\(^5\), decided in 1985 was the first in the series of pharmaceutical cases involving similar fact patterns. Eli Lilly & Co was engaged in the full range of the pharmaceutical business activities, including R&D and manufacturing activities in Indiana, USA. In 1965 it established manufacturing operations in Puerto-Rico and transferred some high-profitable patents to its subsidiary there in exchange for its stock. The subsidiary was a tax exempt entity in Puerto Rico. The subsidiary started to manufacture drugs and sell them to exclusively to Eli Lilly & Co, which resold them to American wholesalers.\(^5\) The IRS examined the activity of Eli Lilly & Co and its subsidiary and came up with a pricing formula under which the entire income derived from the use of the patents was allocated to Eli Lilly & Co. The IRS disregarded the fact that that the profit-producing patents were in the ownership of the subsidiary, because the subsidiary received them for less then arm’s length consideration.

Although the Tax Court disagreed with the IRS on the issue of whether ownership of patents must be disregarded, the Court held that under section 482 the reallocation of income from subsidiary to parent was proper. In deciding the issue on the ALS and reallocation the court came to the conclusion that no comparables could exist for the recently patented drugs. In this situation the usual methods for determining the arm’s length price were not applicable and the court had no other choice but to refer to the

\(^5\) *Eli Lilly & Co v. Commissioner*, 84 T.C. 996 (1985) aff’s in part rev’d in part and remanded , 856 F.2d 855 (7th Cir.1988).
\(^5\) *Id.* at 996.
conventional wisdom of “reasonable split” and allocated to Eli Lilly & Co. profits of the subsidiary in the amount half of the amount offered by the IRS.

Both parties appealed being dissatisfied with the decision. In Lilly’s opinion, the Tax Court correctly rejected the Commissioner’s allocation, but erroneously substituted its own flawed theory that the transfer of intangibles for stock deviated from the ALS and could be a prerequisite for the application of section 482 adjustments. The Court of Appeal upheld the decision of the Tax Court with respect to the application of a reasonable profit split methodology, but remanded for the recalculation of the adjustment.\(^5^3\)

The lesson of this case and similar “pharmaceutical” cases involving transfers of intangible property is that it was not uncommon that comparable transactions cannot be found if intangible property was involved. The courts have to apply allocations that were arbitrary and not grounded in the statute norms. “Court did not attempt to characterize this ... as the product of arm’s length allocation; instead, “court reasoned arm’s length consideration for section 482 purposes is that which results in a clear reflection of income”. This remarkable tautology (the standard for clear reflection is ALS, and the ALS is whatever that results in clear reflection) marks a low point in the courts attempts to apply the ALS in the absence of arm’s length transactions.”\(^5^4\)

Due to the fact that the most difficult problems with respect to the ALS arose when use of intangible property was involved, the last case selected for the analysis is Bausch & Lomb v. Commissioner\(^5^5\), which addressed pricing of the use of licenses. It is one of the most recent section 482 cases. Bausch & Lomb, a US based manufacturer of

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\(^5^3\) 856 F.2d 871-72.
\(^5^4\) See supra note 40 at 126.
contact lenses, established a wholly owned subsidiary in Ireland, which enjoyed Irish tax incentives, and transferred to it a licensed technology of manufacturing of lenses. The subsidiary used the licensed technology in its production process and was selling lenses to Bausch & Lomb and its affiliates, which enabled it to earn significant profits. From the standpoint of the use of intangible assets the scheme was the same as in Eli Lilly, except that in Eli Lilly the subsidiary received the patent for stock, and in Bausch & Lomb the subsidiary paid royalty for the use of license of 5% of net sales of lenses.

The cost of manufacturing for the Irish subsidiary was $1.50 per lens, and the sale price at which Bausch & Lomb had been buying lenses from the subsidiary - $7.50 per each, which actually was the market price for this product. Nevertheless, the IRS stated that this was a deliberate overcharge. The IRS hypothesized that it would be highly unlikely that Bausch & Lomb, which possessed the technology and was able to manufacture lenses at a cost significantly lower then its competitors, would go into the open market to buy lenses at $7.50. The IRS also argued that in an arm's length transaction Bausch & Lomb would not be willing to pay $7.50 because it would receive wholesale price discounts, or at least because the resale of ready made product in the US based on lenses purchased at $7.50 would be economically meaningless and unprofitable.

The IRS made an adjustment of income under section 482 and allocated part of the income of the Irish subsidiary to Bausch & Lomb in the US. The adjustment was not based on the arm's length price but rather used other standards for determining the price and was also based on conclusions of economic experts. The court disagreed with the IRS, holding that: "We thus conclude that respondent abused his discretion and acted

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arbitrarily and unreasonably in allocating income between B&L and B&L Ireland based on the use of the transfer price for contact lenses other than the $7.50 per lens actually used. When conditions for use of the comparable-uncontrolled price are present, use of that method to determine an arm’s length price is mandated. Sec 1.482-2(c)(1)(ii), Income Tax Regs.”

In reaching this conclusion the court relied in part on US Steel, because the decision in US Steel reflected a position of the Second Circuit, where an appeal of Bausch & Lomb was expected to lie. In US Steel the subject matter was transfer price on services, but the court in Bausch & Lomb found it appropriate to apply the decision to other aspects of section 482, including the sale of tangible property. The Court noted that although it would have been more realistic economically for Bausch & Lomb to buy lenses at a more favorable price from an independent contractor, but to decide a case on the basis of such conclusion “would cripple a taxpayer’s ability to rely on the comparable-uncontrolled-price method in establishing transfer pricing by introducing to it a degree of economic sophistication which appears reasonable in theory, but which defies quantification in practice.”

On appeal, the Second Circuit affirmed. It was a debacle for the IRS, because after Bausch & Lomb it became much clear then ever that application of the ALS could be undesirable because of the absurd results it could yield under certain circumstances. US Steel, Eli Lilly, Bausch & Lomb and other major cases revealed serious shortcoming in the ALS application. They “illustrate a major problem in applying the ALS: if inexact comparables are used because the market has changed, or because the relationship between the parties makes for a different nature of transaction, the ALS leads to results

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56 Id. at 589-91.
57 Id.
that are completely unrealistic as an economic matter. Why, then, were the courts in these cases so avid to find that comparables were controlling? The regulations and precedents applying the ALS provide only partial answers. The main reason the courts’ stated awareness of the morass they would be getting into by seeking to determine transfer prices in the absence of comparables. Decisions (not based on comparables) that cover hundreds of pages only to reach unpredictable and arbitrary results seem to justify this conclusion.58 After the decisions in a number of transfer pricing cases, it became obvious that the ALS as it was formulated and applied, lead to uncertainty, where neither taxpayer nor the IRS could foresee what might happen in court. The result in recent cases, such as Bausch & Lomb demonstrated the need to revise the traditional application of the ALS.

d) How Case Law Influenced the Recent Legislative Developments.

Needless to say, the Congress and the IRS responded to the judicial practice. Failures of the IRS to reallocate income of offshore companies back to their US parents by means of the ALS application produced attempts to introduce more viable standards. Starting in 1982 the Congress addressed problematic issues with respect to the ALS raised by the cases, - distortion of income by the MNEs by means of use of research and development activities overseas, absence of comparable transactions, transfer of intangible property and allocation of income resulting from its exploitation.

The Tax Equity and Fiscal Responsibility Act, the Deficit Reduction Act of 1984, and the Tax Reform Act of 1986, which addressed some transfer pricing issues, were the links in a chain of attempts to close the loopholes of the prior law and improve the

58 Supra note 40 at 119.
situation for the future. It was a period of reports, intensive discussions and proposals. Decisions of court in most notorious cases drew attention of scholars, practicing lawyers and economists. At that period structure and the economic essence of the relationships between companies within multinational groups were reassessed.

It was noted for example, that a mechanical comparison of the relationship within a group, which acts as a single economic unit, and between unrelated parties in order to reflect true income of the taxpayer within the group, was not necessarily meaningful. Some authors noted that such a comparison could be misleading, because for many transactions the difference in thinking and approach may be too material.\textsuperscript{59} “That price will rarely be at arm’s length in the narrow sense of the term for the reason that MNEs operate effectively when reaping economies of integration. It is unlikely that any unconnected parties would be carrying out exactly the same type of transaction...”\textsuperscript{60}

The analysis of the practical application of the ALS in cases lead to the conclusion that the concept of comparable transaction did not always work properly. Its conceptual weakness required new solutions. Some of the proposed solutions suggested explicitly or by implication to shift the weight from the ALS to more appropriate standards\textsuperscript{61}. The result of the search of adequate solution was innovations of the 1988 White Paper, 1992 Proposed Regulations and 1993 temporary Regulations.

4. Global Problems Undermining the Value of the Arm’s Length Standard

Arm’s length standard has not only its inherent problems rooted in the legislation and regulations. There are some objective factors in the modern world that add to the complexity with regard to the ALS application.

\textsuperscript{59} J. Pagan, \textit{see supra} note 14 at 27.
\textsuperscript{60} \textit{Id.}
a) Allocation of MNEs’ Income Between Multiple Jurisdictions.

The prerequisite to the problem of allocation of income is the problem of the nationality of the MNEs. The question of the nationality is a general problem arising in the context of international taxation of MNEs, but it is also relevant to the transfer pricing issues.

i) Generally. Expansion of the MNEs created a very specific problem of their nationality and the problem of taxation of the income under different national laws. It is a well-established legal principle that independent states are privileged to exercise sovereignty within their territory, without intervention into the jurisdiction of the other states. Such a system makes a national identity of companies a major factor in the taxation of their income. However, it is not always possible to distinguish between a domestic and a foreign MNE. National corporations move their assets overseas in search of larger markets and lower costs of production, and so become MNEs. American corporations employ personnel abroad in numbers exceeding the personnel employed by the same MNEs in the US, and many MNEs move their research and development and manufacturing activities mostly abroad. The similar situation exists for non-US companies operating in the US.

ii) Difference in interests of national tax authorities and “domestic” MNEs. The first aspect of the problem is a discrepancy between the interests of states and goals of their “domestic” MNEs. National governments prefer that “their” MNEs generate profits for their home countries. Objectively, however, MNEs tend to contribute to different countries where they are involved in business. The commitment of MNE to a national state depends on the type and value of assets located within the state’s territory.

Although it became apparent that it is impossible to retain the wealth within national borders, the tension between the strategies and goals of MNEs and fiscal interests of states may grow. The interest of states is to avoid losses of tax revenues and other economic benefits, resulting from the move of operations by MNEs abroad, while the interest of MNEs is to pursue their global strategies by moving research & development, trade and marketing activities, patents, licenses and other assets abroad in order to maximize profits and minimize expenses. The tension between the priorities creates the potential for future problems. The economic nature of MNEs must be kept in mind by the national tax authorities and legislatures, because the understanding of the nature of conflict helps to keep the government initiatives and approaches towards taxation of international operations of the national MNEs on the right track.

iii) Conflicts between tax authorities of different countries. The second aspect of the problem is the growing tension between tax authorities of different countries with respect to taxation of corporate profits of the MNEs. In this context, transfer pricing problem becomes an increasingly relevant concern for tax authorities because tax authorities of different countries have an interest in the income of the same MNE but may apply different standards in determining arm’s length prices and, consequently make different adjustments to the same transactions. Understandably, by establishing and administering transfer pricing rules, national jurisdictions protect their national financial independence. The interests of the MNEs, which operate as a single economic unit in several jurisdictions, are generally not taken into consideration. This discrepancy in interests, as well as disagreement between the competing tax authorities on the rules of
the taxation of the MNEs can lead to the situations when income is undertaxed or, which is more likely, overtaxed through multiple taxation.

The problem of multiple taxation of the income of MNEs is currently addressed in double taxation treaties. Treaties generally address the problem by providing for exemptions or tax rate reductions in the tax imposed by the country of source and by providing for the foreign tax credits. However, neither the US Model Treaty nor model treaties developed by the OECD or the UN contain comprehensive source rules for business income derived from sale of goods and services. This illustrates that the national tax authorities rely rather on their domestic approaches and standards for the allocation of income of the MNEs rather than mutual agreements.

The approach of the majority of countries to transfer pricing accepts the arm’s length standard, introduced by the US and recommended for the adoption by others. The ALS approach requires a comparable transaction between unrelated parties. The ALS approach does not address the issue how to allocate income between countries of source, because its main concern is how to allocate the income between commonly controlled entities. Therefore, the practical consequences of the application of the ALS by the “revenue-hungry” national tax authorities inevitably leads to the competition between the jurisdictions as well as to multiple taxation of the MNEs. By leaving the above matter unresolved, the ALS approach demonstrated its weakness and inability to cope in full with taxation of the international business income.

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The seriousness of tax consequences at the international level can be illustrated by the example of "tax wars". One of the most notorious examples of the tension between the competing tax authorities was the conflict with respect to section 482 between the US and Japan in the beginning of 1990s. During that period, the IRS repeatedly reported a widespread tax underpayment caused by the use of the transfer pricing schemes by foreign companies. Among "the most egregious transfer pricing abusers" were the US subsidiaries of the Japanese corporations. To reduce the deficit from the underpayment of revenues estimated on the part of the Japanese-controlled companies, the IRS decided to closely scrutinize the practices of these companies. Although it was found that about 50% of the difference in the taxable income between foreign-controlled corporations and domestic corporations was not attributable to transfer pricing, many Japanese-controlled companies were found artificially increasing the income of their parent companies in Japan by intentionally shifting substantial part of profits in the form of commissions, licensing fees, royalties and patent fees. By reason of transfer pricing, the US tax authorities during this period assessed additional tax liabilities to more then 100 Japanese-controlled corporations operating in the US, and an additional 100 corporations reported they expected problems in the future.

According to some observers the IRS breached the US-Japan Tax Treaty, which prohibits double taxation and allows a foreign tax credit to multinational companies, and

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67 *Id.* at 415. Among factors that reduce the taxable income of foreign corporations are fluctuating exchange rates, start-up costs, greater reliance on outside supplies, etc.

68 *Id.* at 410.

69 *Id. See also* p.420 on the lack of the tax strategy of the Japanese companies in the US. Before the Toyota ($ 266 m. additional tax collected) and Nissan ($574 m.) transfer pricing cases became publicly known in the mid.1980s, the most of the Japanese companies do not consider international tax issues as a part of a corporate strategy as all.
pressed Japanese MNEs to secure their tax payments in the US.70 The National Tax Administration of Japan demonstrated a similar approach in response. “Although it is Japanese multinational corporations that are in dispute with the IRS over tax liabilities, the substance of the dispute is government-to-government... In sum, the two governments are fighting for the tax returns filed by multinational corporations and are trying to ensure that the “tax pie” gets distributed according to the jurisdictions where the tax value is created.”71 This is an additional proof that transfer pricing is not only a tax issue. However, far more important is the conclusion that the current system of transfer pricing rules focused exclusively on the comparability of transactions and hypothetical arm’s length prices, without clear rules on allocation of income internationally, has too many flaws and has to be improved to avoid such conflicts in the future.

iv) Points of concern stated. Some commentators mentioned the lack of international rules for geographic allocation of income or loss from the international business transactions and the lack of rules determining what is a comparable transaction among the main concerns with respect to the existing system of allocation of international income between jurisdictions.72 A closer examination of each of these issues reveals a number of related problems. Wrong approaches taken by the IRS contributed to the failure of the present system to fairly allocate income between jurisdictions. For example, it was noted that the IRS focuses its attention on the wrong task by concentrating on the question of what prices are right for the intercompany transfers instead of what portion of the income or loss should be allocated between jurisdictions. “Price and profits are obviously not the same; they are very different and ought not to be confused with one

70 Id.
71 Id.
Another example of the wrong approach is the deliberate avoidance on the part of the IRS to establish “bright line” rules instead of using case-by-case approach.

v) Preliminary conclusion. The conclusion that can be drawn from the above discussion is that the major problems relevant to the allocation of income internationally have their roots in the ALS. To deal with the problem of the international allocation of income of the MNEs becomes a necessity. Therefore, it is a high time to reassess the importance of the ALS as the cornerstone of the present system of transfer pricing rules. The approaches of the national tax authorities to the standards used to measure transfer pricing transactions in different jurisdictions may be different, which may be explained by a combination of different factors, but the goals for which the transfer pricing rules were established are essentially identical for any jurisdiction. To proceed with the development of the national transfer pricing legislations further means to establish standards which allow a fair allocation of income of MNEs between jurisdictions, or, alternatively, to establish clear rules for the resolution of transfer pricing disputes between states without significant changes of national tax systems. This will permit a decrease in the manifestations of “nationalism” with respect to transfer prices and will help the tax authorities of different jurisdictions to formulate a sound tax policy in this field. In the meantime, while tax officials of different states try to pull the “tax” blanket from each other, the system of traditional transfer pricing rules hurts the interests of MNEs and creates obstacles in their economical development.

\(^{72}\) Supra note 65 at 348-349.
\(^{73}\) Id. at 345.
b) Transfer Pricing and E-commerce

i) General concern for tax authorities. Electronic commerce presents a new challenge for the tax authorities around the world. E-commerce is a broad term, which encompasses business activities by means of exchange of information in a cyberspace, the new dimension created by the means of telecommunication. The fact that e-commerce transactions can be conducted in a unified single economic unit, where national boundaries are irrelevant, requires conceptual reassessment of many principles of international taxation.

A typical e-commerce transaction does not fit into the traditional international tax regime where profits attributable to a permanent establishment are allocated to the source country. This issue, which is only a top of the iceberg, referred to by many commentators as the problem of the determining of the jurisdiction. Emergence of e-commerce also brought several critical issues to the traditional approaches to the transfer of price. Among the general articulated concerns are: lost tax revenues through improper administration of tax rules, fair allocation of tax revenues among jurisdictions, multiple taxation by several countries of the same MNE profits and the fear that the transfer pricing regulations become increasingly burdensome.\textsuperscript{74} To formulate the arising problems more precisely, the problems of e-commerce and transfer pricing are problems of a comparability of e-commerce transactions, questions of whether the permanent establishment exist and problems of taxing of highly integrated companies.\textsuperscript{75}


\textsuperscript{75} These particular problems were indicated in US Treasury Department White Paper on tax Policy Implications of Global Electronic Commerce. Cited in Kelley L. Mayer, Reform of the United States Tax Rules Governing Electronic Commerce Transfer Pricing, 21 T. Jefferson L. Rev. 283 (1999), note 64.
ii) Difficulties in categorization of income. Historically, transfer pricing focused on transactions involving a transfer of tangible goods. New technological age brought the new understanding of the word “goods”. In 1996, the Office of Tax Policy of the US Treasury prepared a report on the policy implication of e-commerce\(^7\). The Report stated that goods and services could have a physical presence or be intangible or digital, in the sense that they do not exist outside of a computer. The development of new products made it a difficult task in some cases to determine whether taxpayer involved in trade of tangible goods or use of intangibles or rendering of services. This classification is important, because under the US tax laws, the classification is crucial for determination of the source of income and sometimes for the application of appropriate tax regime. Moreover, international tax treaties provide for different income taxation regimes in cases involving a sale of goods, use of intangibles or rendering of services. In the context of transfer pricing, this problem creates a great administrative burden of the prevention of tax avoidance as well as categorization of income of the MNEs.

iii) Difficulties in finding comparable transactions. The extent to which arm’s length price is determined correctly depends greatly on the degree of the comparability of the transactions. The existing judicial practice demonstrated that in some instances it is highly problematic to find a comparable transaction or price even for a “traditional” transaction, especially where the transfer of intangible property involved. In case of e-commerce transactions, where new and often incomparable by definition intangibles are used, it becomes just impossible to rely on the comparability.

iv) Permanent establishment. Currently, the treatment of income from e-business is considered to be within the permanent establishment framework. Permanent establishment is a concept that played an important role in the allocating of income among jurisdictions. In 1927 one of the committees of the League of Nations introduced a draft of a model bilateral tax treaty, which contained a concept of a "permanent establishment". Since then, this notion remained essentially unchanged. "The use of the permanent establishment concept as a demarcation point for source-country taxation was probably sensible at a time when physical presence was required in foreign markets to conduct significant business operations. Hence, the permanent establishment concept arguably provided a reasonable compromise between the interest of countries that exported goods, services and capital, and countries that tended to import goods, services and capital because both of these countries shared tax revenues derived from international trade. The emergence of electronic commerce, however, threatened this compromise since this new commercial medium does not require any physical presence within the source country".

According to the 1996 US Model Income Tax Convention, the term "permanent establishment" means "a fixed place of business through which the business of an enterprise is wholly or partly carried on", like a place of management, a branch, office, a factory or a place of extraction of mineral resources. For the purposes of structuring transfer pricing transaction it is important to determine whether permanent establishment exists, because the permanent establishment, like a branch of the taxpayer in a different

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78 Id. at 136.
country, may constitute a "related party" for the taxpayer. Similarly, tax authorities need the clarity in understanding what constitute a permanent establishment for a taxpayer involved in e-commerce because, again, it helps to determine whether parties are related and, consequently, to determine the appropriate tax treatment for transactions between them. However, the development of e-commerce may make the whole concept of a permanent establishment irrelevant due to the irrelevance of the physical presence factor. In the meantime, scholars and specialists continue their debates what may and what may not be the permanent establishment in e-commerce. 

\textit{v) Integration of enterprises.} Business in e-commerce is highly integrated, which adds to the problem for tax authorities. In some instances it might be impossible to make a breakdown of a complex e-commerce transaction and to evaluate its elements separately. A hypothetical example of a routine order and delivery of the book from the Amazon.com demonstrates that the bookstore, the publisher and the transportation company are fully integrated, and evaluation of the transaction on the basis of the traditional arm's length principle can be problematic. "Combination of goods and services was traditionally available only by having a representative visit the consumer's residence of place of business. Many service transactions can now be consummated over the Internet. The time between provision and consumption has decreased so drastically, that taxing entities cannot identify the transaction source. Additionally, the forum for

provision and consumption is extremely mobile, further complicating identification of the
transaction sources.\textsuperscript{82}

\textit{vi) Comment on the e-commerce problems.} The present system of transfer pricing
rules is not workable for e-commerce transactions. That does not mean that e-commerce
raises completely new problems. Rather, the problems raised are derivative from “old”
difficulties which transfer pricing system always confronted. E-commerce just aggravated
these existing problems, and created additional incentive for MNEs to move business
offshore to avoid administratively burdensome transfer pricing regulations.

Understandably, this revolutionary technological breakthrough has caught the tax
authorities unprepared and they have been wondering in the dark for some time, without
actual knowledge how to administer traditional tax rules in a new cyber reality. If the
expected growth of e-commerce continues in its present rate, the phenomenon of making
money in the Internet threatens to become the most serious challenge for current transfer
pricing rules and the international taxation in general. The problem of the allocation of
income of the MNEs between jurisdictions and the problem of e-commerce are related
closely and can be considered together for the purpose of searching of appropriate
solutions.

A number of the proposed solutions for taxation of e-commerce range from “do
nothing” to the bold innovative rules\textsuperscript{83}. To confront these problems will definitely require
an unprecedented level of international cooperation. Despite the fact that an international

\textsuperscript{82} See supra note 74.

\textsuperscript{83} Supra note 81. Professor Cockfield analyzed advantages and shortcomings of the following alternatives
to taxing e-commerce business profits: 1) to do nothing, i.e. to allow existing regime to handle the
challenges; 2) to focus on the residence-based taxation of e-commerce as an alternative to source based
taxation of income; 3) to allocate tax base among jurisdictions according to some formula; 4) to use some
fictions that allow to determine a source state by meant of a treaty, and 5) to develop destination-based
rules, i.e. rules based on the ultimate destination of e-commerce goods and services
body like WTO does not exist for tax matters, and the OECD is restricted to its member countries, the chance to achieve international consensus is considered as real. But due to the difficulties of reaching this consensus quickly it is highly unlikely that the radical changes will take place soon. More realistically, in the nearest future we will see modifications of existing bilateral tax treaties as well as the work of the national legislatures on making necessary adjustments to the national tax legislations by introducing changes in line with the existing principles of international taxation.

5. Skepticism Regarding the Arm’s Length Standard in the US

Taxpayers and tax authorities in the US questioned the effectiveness of the ALS repeatedly. The general criticism expressed by numerous commentators is that the ALS as a standard is impractical. Main objections are that the ALS does not work in many situations, that it creates uncertainties and administrative burden and does not eliminate the possibility of double taxation. Many commentators believe that the ALS is also unsound theoretically and does not reflect the economic reality of contemporary international business.

i) Theoretical flaws. According to some commentators, the ALS contradicts the very idea and essence of the multinational enterprises as a phenomenon and reality of today’s world economy. “In economic theory, affiliates of a MNC [multinational corporation] would not necessarily be expected to treat other affiliates as wholly separate corporations or to choose arm’s length prices for their transfers, since affiliation may give rise to a variety of synergetic effects which alter the costs and benefits of transacting intercompany business… Related parties know that they will realize the benefits of

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84 Id. at 165.
synergy only on intercompany transactions and that any one party, if it chooses to deal with outsiders, will deprive other affiliated of their profits. This observation makes a big sense, because the integration of a MNE is what creates market advantages, allowing MNEs to develop and actively compete in the modern world. When transactional costs are lower, business is more effective. Unfortunately, by presenting the "independence of parties" as a standard, the promulgators of the ALS did not take the above factor into consideration.

"Continuum price" problem is another theoretical implication, often mentioned by the critics of the ALS. If the ALS presumes that market rates of return should be applied to separate components of MNEs, the result will still be less than an overall actual return of the MNE as a single unit. As was stated above, interaction between parts of the MNE creates certain economical advantages resulting in "additional" profits. The problem is that these profits, or "residual", cannot be assigned to any component of the MNE and, conceptually, no correct method of allocation of this "surplus" may exist. This is a continuum, and any artificial rule that prescribes some allocation will be arbitrary.

The arguments articulated above provide the ALS critics with the firm ground to argue that the traditional ALS distorts the existing realities, and the theoretical flaws of the concept will inevitably result in the practical difficulties of its application.

ii) Practical problems. Judicial practice was the main indicator of the shortcomings of the ALS. The judicial practice over the last two decades allows one to came to a conclusion that the ALS as a standard is insufficiently developed to cope with the full range of the transfer pricing problems. Despite the long legislative history of the

85 Fuller, Note, Multinational Corporations and Income Allocation Under Section 482 of the Internal Revenue Code, 89 Harv. L. Rev. 1202 (1976), cited in Stanley I. Langbein, The Unitary Method and the
ALS, analytical reports, the IRS regulations, and judicial decisions, the workable rules for establishing of the arm’s length prices were not created. The lack of rules for determining the transfer of prices was acknowledged by the Treasury and the IRS in the 1988 White Paper: “One of the most consistent criticisms of section 482 regulations is that they do not provide taxpayers with enough certainty to establish intercompany prices that will satisfy the Service without overpaying taxes. Based on the Government’s experience in litigation, the current section 482 regulations also fail to provide the Service and the courts with sufficiently precise rules to make appropriate section 482 adjustments, especially when third-party comparables are not available.”

Existing rules based on the ALS preclude uniform application in specific cases. The IRS has never stated in administrative procedures or in courts the principles underlying existing transfer pricing methodology. “…Chief Judge Nims of the US Tax Court remarked that, “getting an agreed statement of the issues is the single most difficult and most significant part of the job of a trial judge in a large section 482 case, due to an unwillingness on the part of the IRS to be pinned down to a theory”. Moreover, Judge Nims unfavorably commented on the burden created by the present system of rules, stating that transfer pricing cases absorbed a substantial part of the Tax Court resources.

Traditional ALS leads to a situation when the corporate transaction cannot be structured in advance, because of the inability to foresee the economical result of the transaction and the uncertainty of the result of the litigation. All this may have an adverse affect on the starting new business projects abroad.

86 White Paper, supra note 24, at S-12.
88 R. Avi-Yonah, supra note 40 at 150.
A cost of compliance for MNEs and the cost of enforcement for tax authorities are enormous. "The only winners under Treasury’s current arm’s length approach are many professional middlemen- accountants, tax auditors, lawyers, economists, valuation experts, technical information publishers and other professionals. The big losers are principal parties in interest, international businesses and countries. Governments incur high enforcement costs and also lose revenues that could be collected under a set of clearer rules. The economies suffer from having resources diverted to the private sector’s costs for compliance. Because of this, both private and public sector officials would be well advised to institute a far less costly system". 89

A growing problem for both the tax authorities and the MNEs may be the possible complications in determination of what constitutes a related party. The MNEs are experienced constant growth. In such situation, too many companies may fall under the definition of related parties, to which transfer pricing rules will be applicable. Strategic alliances may complicate the issue even more 90. Enforcement of section 482, which initially was directed against tax avoidance practices, may be directed against companies, which do not use transfer pricing for tax avoidance, and they may become subject to all transfer pricing policies and procedures.

The disadvantages of the ALS are obvious. The criticism of the ALS is widespread and seems to never end. Thus, in the face of the increasing globalization of business and growing importance of transfer pricing issues the search for alternative approaches becomes a necessity.

89 D. Wickham, supra note 65 at 351.
6. Alternative Approaches.

a) Formulary Apportionment

i) Essence of the method. The most real alternative for the ALS mentioned by almost all the ALS opponents is the formulary apportionment (unitary business) method. The idea to accept this method has been in the air since 1962, when the Congress recommended to the Treasury to study the possibility of working out the formulary apportionment for allocating of income and deductions as the alternative for the ALS-based regulations for section 482.

Formulary apportionment assigns income of MNEs to a country by reference to a formula. According to this method the separate parts of the MNE are treated as a single economic unit, and the income of this MNE is apportioned among different tax jurisdictions on the basis of a mechanically applied mathematical formula made out on the basis of the three factors of assets, payroll and sales in each jurisdiction involved.

ii) Case law. This method has been applied in practice under the law of certain states, e.g. California. Cases dealing with the formulary apportionment made their way to the US Supreme Court. For example, in Container Corporation of America v. Franchise Tax Board the US Supreme Court made some general observations on this method. It held that formula apportionment method rejects geographical or transactional accounting. The method calculates the tax base of the company operating in several jurisdictions by means of determining the scope of the “unitary business” and then allocating the total income from the “unitary business” on the basis of the objective

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90 See e.g. J.Pagan, supra note 14, about alliance of Dutch based Philips and German Grundig and other examples, at 25.
91 P. Muchlinsky, supra note 15, at 299.
measures of the activity of a taxpayer within and without the jurisdiction. The main advantage of the formulary apportionment method over the ALS is that the former is easier to administer.

**iii) Practical difficulties.** However, there are some difficulties with respect to the application of this method too. The first problem is to determine what are the taxpayers to whom this method should be applied. For the formulary apportionment to be applied, the taxpayer must be viewed as a part of a “unitary business”, and it is not always clear to what extent the company acts as a part of a “united business entity”. This issue is probably the major inherent problem of the method.

Another difficulty is that no precise formula of allocation exists. Allocation under the formula calculated on the basis of payroll, assets, and sales of the unitary business in several jurisdictions involve a risk of double taxation. Under the US law, the formula must be applied fairly to the taxing jurisdiction and must not result in discrimination against foreign commerce. The above difficulties and the number of other considerations preclude interested parties from the consensus on the application of the formula as the right alternative to the ALS.

In 1979, the OECD rejected this approach on the grounds that it would lead to the arbitrary allocation of income and have a side effect of the renegotiation of tax treaty network. Strong opposition to the formulary approach also exists among the US and foreign MNEs, as well as foreign governments, most notably the United Kingdom, which adopted a norm under the Finance Act 1985 providing for the retaliatory measures against US companies operating in the UK, if the British MNEs will be taxed under the

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93 *Id.*

94 See Container Corporation, supra note 92.
formulary method. A number of suits were filed in the US by foreign based MNEs seeking to prevent the US tax authorities from application of the worldwide apportionment method to these MNEs, and from obtaining information about them necessary to apportion their income.

The major objection articulated so far has been that the double taxation is inevitable under this method. Moreover, the apportionment on the basis payroll-assets-sales formula will always tend to shift the major part of profits to more economically developed countries, where prices and wages are higher. For example, in Container Corporation only 13% of the US company “unitary business” income was allocated to its Latin America operations, which was less than half of the ALS-would-be amount. Also, Justice Powell and Justice O’Connor dissenting opinion in Container Corporation reflected that the formulary apportionment under the California law “clearly violates the Foreign Commerce Clause” of the US Constitution, and that the problem of double taxation “cannot be eliminated without either California or the international community changing its basic tax practices”.

iv) International status of the ALS as an obstacle to its replacement. Another serious objection to the formulary apportionment is that the ALS is allegedly an international norm, and that it is difficult to change the approach through unilateral actions. In one of its reports the US Treasury stated that the “internationality” of the ALS was a fact: “The standard that the IRS applies in a transfer pricing case is the

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96 Supra note 14 at 301.
98 Container Corporation, supra note 92, at 182
99 Id.
100 Id. at 574 –575.
internationally accepted arm's length standard... The arm's length standard is
incorporated in all US income tax treaties (as well as almost all other income tax treaties).
In addition, the arm's length standard has been explicitly endorsed by international
organizations such as the OECD and the United Nations. Every major industrial nation
accepts the arm's length standard as its frame of reference in the transfer pricing
cases"\textsuperscript{101}. Despite these assertions, the status of the ALS of an international norm was
seriously challenged by several commentators.\textsuperscript{102}

Professor Langbein, who followed the “career” of the ALS starting from the work
of the League of Nations in the 1920s, argued that the ALS is hardly an international
standard: “...most countries not only had no specific legislation aimed at the international
context, many did not have even general anti-avoidance legislation, like our section 482,
which could be or was used to reach the international context. And no country, including
those with specific legislation, has regulations elaborating arm’s length standard method
remotely comparable to the regulations the United States adopted during the
1960s.....The arm’s length method was, except in a handful of cases, not the product of
legislative act anywhere...”\textsuperscript{103} However, even if the ALS is not truly a “norm” and is of
descriptive rather than prescriptive nature, the approach of section 482 became widely
adopted, and established a sort of a cliché of taxation of the worldwide income of
multinationals.

All the above demonstrated that the objections to the worldwide application of the
formulary apportionment are serious enough and, until the international consensus on the
\textsuperscript{101} US Treasury Department and Internal Revenue Service, Report on the Application and Administration
of Section 482, April 9, 1992, at 1-3&4. Essentially the same statement is made in 1998 White Paper.
\textsuperscript{102} See e.g. Stanley I. Langbein, The Unitary method and the Myth of Arm’s Length, 30 Tax Notes 625, 656,
1986., also see B. Lepard, supra note 23.
application of the method is reached, the implementation of the formulary apportionment can be even more problematic than the use of the arm’s length pricing. Apparently, the above considerations were among those that made the Treasury in 1962 reject the formulary apportionment in favor of the ALS, which was later spread throughout the world.

b) Advance Pricing Agreement as Possible Solution.

An advance pricing agreement, or an APA, is another response of the US tax authorities to the practical difficulties of the application of the ALS. The procedure was introduced in 1991. According to the APA, the taxpayer may come to an agreement with the IRS on the applicable transfer pricing method in advance. In effect, the APA is a mechanism for voluntary compliance that reduces the administrative burden and the amount of litigation, “a vehicle for a relatively informal and businesslike way of heading off potential disputes…” 104.

According to the Revenue Procedure 91-92, which serves as a guideline for the APA, the procedure is as follows. The MNE should submit a request and provide detailed information on the pricing plan and methodology chosen for the future transactions. The IRS considers the submitted information and either agrees with the taxpayer in writing or not. 105 As a result, successful APA gives the taxpayer the desired certainty with respect to the treatment of his transfer pricing activities.

The APA is a binding agreement that can be unilateral i.e. agreed to by the IRS, or bilateral or multilateral, including two or more tax authorities from different jurisdictions. It can significantly simplify the procedure of dealing with tax authorities in

102 S. Langbein, supra note 102 at 640-41.
103 J. Pagan, supra note 14 at 197.
different jurisdictions. The APA is recognized by many countries as a useful device in
dealing with transfer pricing problems. A number of countries, including Australia,
Canada, Japan enacted legislation to establish their APA programs.\textsuperscript{106}

Although the APA has a number of positive aspects, some problems are
inevitable. The process for applying and obtaining an APA can be a very long and
expensive one. The documentation to be submitted by a taxpayer is similar to the
documentation required by the discovery procedure under section 482 litigation. And the
chance of the litigation still remains, because the APA does not shelter the taxpayer from
subsequent scrutiny by the IRS. The APA is flexible, may be too flexible, because it is
not subject to any standards. That means the APA may be based on the formulary
apportionment approach as well as on the arm’s length principle. Besides, the APA is not
published. “This leads to the impression that the Service is in effect cutting deals with
well-off corporate taxpayers which remain secret and are not subject to any general
standard of law or any other review”\textsuperscript{107}. The case-by-case approach is not acceptable for
transfer pricing matters, especially in the international context. The APA case-by-case
approach is the alternative for the ALS, a substitute, but it cannot be a solution, because
the real alternative and ultimate goal is to develop rules of general application, sound
rules of law, which are so badly needed.

7. Conclusion Remarks to the Chapter II.

The ALS come a long way in the US. The history of its development
demonstrated both its benefits and disadvantages. Transfer pricing is not an exact science,

\textsuperscript{106} R. Tang,\textit{ supra} note 26 at 95.
and the ALS might not necessarily the best and universal solution. Moreover, the whole range of problems above demonstrated the weakness of the traditional ALS and showed its fundamental deficiencies. However, the US “classical” approach remains important because it was used as a model by the rest of the world. The economic hegemony of the US in the world and its authority in international organizations created a situation when the US tax policies in international taxation influence other countries, and no essentially new decisions may be taken without coordination of plans. Under such circumstances the question arises whether other countries are stuck with the ALS. Do they have to follow in the wake of the “big brother” who adopted the ALS first and spread it around the world stating that it was the most efficient solution of the problem? Below the author attempts to analyze a question whether there is anything beyond traditional ALS that may be adopted by a country, which just started to develop its national transfer pricing legislation, and what possibly may happen if national approach will not be consistent with the US-like approach.

107 R. Avi-Yonah, supra note 40 at 155.
CHAPTER III. RUSSIA DEVELOPS ITS TRANSFER PRICING LAW

   a) Overview. New Russian Tax Code

Despite the fact the tax reform has succeeded to a certain extent, Russia has not
developed transfer pricing legislation so far. The analysis of the problems with respect to
development of the ALS in the US, the country that introduced it and used it for more
than 60 years, is useful in order to understand what sort of transfer pricing legislation
Russia may need at the given point of its economical development.

The current technical state of Russian tax system can be explained by the
peculiarities of the country's transitional period in the economy. One of the milestones in
its development was 1998, when the Part One (General Part) of the new Tax Code was
adopted. Until 1998, the technical state of the RF tax system could be characterized as
a chaotic. It was a tax system that stemmed from the Communist past and which to a
large degree was a result of a compromise between the necessity to collect at least some
revenues and the general understanding that taxpayers are unlikely to pay all existing
federal and local taxes, which would be equal to almost 90% of their income. It was a
system permanently driven by the necessity to collect revenues at any cost in the never-
ending crisis situation. Until 1996, the list of taxes, levied in the RF on all the levels,
totaled forty one, but in 1996, pursuant to the Edict of the RF President, the RF subjects

108 Federal Act "On the Enactment of the First Part of the Tax Code of Russian Federation", Ross. Gazeta,
6 August, 1998. First Part of the Tax Code came into force Jan.1, 1999 (hereinafter referred to as Tax
Code). All the cited official acts and judicial decisions are available at www. Consultant.ru
and local authorities quickly increased this number up to two hundred. An attempt to overview all the taxes as they are excised in the RF would have resulted in a compilation of endless tax innovations. The State traditionally attempted to ensure tax collection through employment of punitive measures, such as astronomical fines for non-compliance and tax evasion, and chose to provide limitless discretion to the State Tax System (STS) as means of enforcement.

Many of these “old” approaches seem to have been flatly rejected by the Tax Code authors in favor of measures facilitating voluntary compliance, rather than forcing the collection of taxes, bringing the “fair play” elements, such as the presumption of innocence and limitations on the STS’ discretion, into the interrelations between the taxpayers, the State and the STS. This approach also requires the judiciary to play a more active role in the tax system and there are indications that the judiciary is becoming more independent and less state-oriented. New Tax Code introduced a system of general principles of tax collection policies in Russia and effectively replaced most of the legislative acts that comprised Russia’s tax system prior to January 1, 1999.

b) Potential for Tax Abuse

However, in an attempt to provide the federal budget with a steady stream of revenues, Russian tax authorities seemed to forget about the regulation of the transaction between related parties. This may be explained by the following reasons. First of all, the

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109 See Edict of the RF President of December 22, 1993 No. 2270 “On some changes in the collection of taxes and interrelations between budgets of different levels.”
110 The RF State Tax Service has been transformed into the RF Ministry on Taxes and Duties, but the abbreviation continues to be popular among commentators. See Edict of the RF President No.1635 of December, 23, 1998 “On the Ministry of Russian Federation on Taxes and Duties.”
111 See Tax Code art. 6.
priority for the tax authorities was to create the fundamentals of the tax system and to improve the collection rather then to work out detailed rules for the taxation of income of Russian MNEs. Secondly, for a long time Russian financial–industrial groups that formed around leading banks and oil companies possessed little if any understanding of a traditional MNE, because they had no production activities abroad. This situation showed some similarity to the situation that existed in the US in 1920-30s, when the primary concern was the domestic tax evasion issues rather then taxation of the foreign income.

However, high taxes, strict currency requirements and limitations lead to the situation where Russian companies and foreign companies operating in Russia through their subsidiaries could cope with the tax burden largely through use of off-shore based companies and transfer pricing schemes. In the absence of the law on the inter-company pricing taxpayers allowed themselves to be far more flexible (sometimes even commercially unreasonable) in establishing prices for the intragroup transactions in Russia compared to other countries. Absence of the transfer pricing rules contributed greatly to tax evasion that has reached a scale that threatened a national economy.\textsuperscript{113}

2. How the Problem of Transfer Pricing is Currently Addressed

a) Article 40 and Article 20 of the Russian Tax Code.

The attempt to address transfer pricing issues was made in the Part one of the Tax Code in 1998.

\textsuperscript{112} See e.g., Verkh. Sud RF No. GKPI 98-448; see also The Decision of the Constitutional Court of the RF, November 11, 1997, No.16-P.

\textsuperscript{113} It was admitted officially in 1997 that the scope of the “grey” and “black” economy has reached 50\%.
The provision of the Tax Code dealing with transfer pricing is contained in Article 40 "Principles of Determining the Price of Goods, Work or Services for Taxation Purposes". It states that, unless otherwise proved, the prices established by the parties to a transaction are assumed to be consistent with market prices. The tax authorities are entitled to control the proper use of prices in transactions between interdependent persons, with respect to barter transactions, foreign trade operations, and in transactions where upward or downward deviation in the market price for similar goods or services is more than 20%. If the prices of goods, work or services established by the parties deviate by more then 20% against market prices, the tax authority may charge additional tax and assess penalties calculated as if the transaction was entered into based on market prices.\(^\text{114}\) Article 40 also contains the following important provision: "...if there are no transactions involving identical goods, work or services, and where it is impossible to determine the prices in question because of the inaccessibility of the sources of the information, the market price shall be determined using the subsequent sale method....Where the price under subsequent sale method cannot be established, ... the cost method shall be used, whereby the market price of goods, work, services is determined as the sum of costs incurred and such profits as is normal for the area of this activity..."\(^\text{115}\) Article 40 provides also for rules for determining identity of goods, work and services. However, Article 40 created only a broad framework for the transfer pricing rules.

Another provision, which is a part of a transfer pricing control system, is Article 20 of the Tax Code. It determines the interdependency of parties to the transaction. One

\(^{114}\) Tax Code, art. 40 (1), (2).
\(^{115}\) Id. (Translation of the author).
year after the adoption of the Part One of the Tax Code the State Duma\textsuperscript{116} revisited Article 20 and adopted amendments that broadened the definition of interrelated parties\textsuperscript{117}. Under the original version companies were considered interdependent if they have direct or indirect interest of more than 20\% in one another or holding more than 20\% of assets of one another\textsuperscript{118}. According to the amendments physical and legal persons may be considered as interdependent parties “on the other grounds not envisaged [by clause 1 of Article 20] if the relationship between those persons can influence the results of transactions...”.\textsuperscript{119} Whether the effect of such a broad interpretation of the related parties will be positive is yet unclear.

The whole Russian transfer pricing legislation consists of Article 20 and Article 40 of the Tax Code. These provisions which are far from comprehensive provided some confusion. It is obvious that the future guidance is needed.

b) Insufficiency of Regulation and Possible Practical Problems

There may be several explanations why transfer pricing law is so laconic and not sophisticated in Russia. To begin with, the primary need was to establish at least some sort of a legal framework for the transfer pricing legislation. One of the peculiarities of the Russian transfer pricing rules is that they were established to target mostly Russian domestic entities, mainly oil and natural gas companies. Taxation of hydrocarbon production will remain a priority for Russian government for a long time, because a dozen of large natural resources extracting businesses provide the Russian budget with

\textsuperscript{116} The name of the lower Camber of the Russian Parliament.

\textsuperscript{117} Federal Laws of the Russian Federation # 154-FZ of 06 August, 1999.

\textsuperscript{118} Supra note 108.

about 50% of the revenues. This to a certain extent explains the language of the transfer pricing law, absence of details, and absence of regulations.

Apparently, the logic of the tax authorities is straightforward. Transfer pricing law in its current version, even without the regulations, will enable the STS to squeeze a lot of additional revenues from the domestic hydrocarbon producers, which constantly use simplistic and unsophisticated transfer pricing schemes to avoid taxation. Under these circumstances, the STS can allow itself temporarily not to pay attention to a “small fish” which continues to keep low profile and to foreign companies conducting Russian operations, the number of which is not very significant. Such a practical approach to creation of the tax laws in order to achieve temporary success was typical for Russian tax authorities in the pre-Code period, but now we can see it between lines in the Tax Code. The problem, however, is that the consequences of the insufficient regulatory mechanism will inevitably result in uncertainty for both taxpayers and tax authorities.

Practitioners in Moscow pointed out a number of huge loopholes in Russian transfer pricing law. For example, the current version of the transfer pricing provisions does not deal with financial transactions, and a simple loan may be treated as a provision of services, which makes it subject to transfer pricing rules. Similarly, Articles 20 and 40 do not provide clear cut rules for determining of what constitutes a market price. One of the biggest problems becomes the super generic definition of the related parties.

"Under a literal reading of Article 20, any transaction in theory can result in

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121 See e.g. The Wall Street Journal 30 Nov. 2000 about Tumen Oil Company. Russian oil companies are using offshore and other trading schemes to avoid paying $ 9 billion in taxes annually, according to the Russian tax police. A Finance Ministry spokesman said oil companies use transfer pricing methods to minimize their tax payments. Although methods are considered legal, they represent a huge losses to the federal budget. available in the Internet www.tnk.ru
interdependence of the parties that enter into it, whether or not according to the OECD rules or common sense they are actually related", said one of the representatives of Ernst & Yong Moscow. The adoption of a super broad definition of a related party caught attention of some of the OECD officials, who expressed concern that such a broad definition would require clear rules on what kind of financial participation is needed for to constitute a control. Provisions with respect to the fluctuation of prices by not more then 20% of the market price could create problems for services providers, who set low prices when they render service for the first time to a new customer. One more concern of the practitioners is that the law implied the existence of one market price, whereas in the absence of the clear rules the use of different pricing methodologies may produce several market prices.

But what is the most interesting is that Russian transfer pricing law did not establish directly the concept of the arm’s length standard. Because market prices are taken as measure of the transaction between related parties, it can be implied that the ALS underlies Russian transfer pricing control system. Nevertheless, it is not that clear. In this context a question arises whether it was a failure of the Tax Code not to establish the ALS.

3. Is It Necessary to Develop the Arm’s Length Standard?

Undoubtedly, insufficient regulation of the transfer of price is a disadvantage. But how detailed do the transfer pricing legislation have to be? Is it necessary to state

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122 See supra note 120.
124 Id.
explicitly the applicable standards for “measuring” transactions? It would be interesting to analyze the question whether Russia needs to follow in the wake of the US or the OECD guidelines to establish a sound transfer pricing control system.

The Russian legislature and tax authorities may learn a lot from the experience of their US colleagues with respect to the regulation of transfer of price. It is known fact that the US experts took an active part in the creation of the Russian new Tax Code. Possibly, Russian tax authorities may have an opportunity to have a “free ride” on the efforts of the IRS by introducing the ALS and by following existing models of the transfer pricing legislations. The question is whether it is really necessary to accept existing models of countries with successful tax system.

According to the OECD, the ALS is a standard accepted worldwide. However, as it can be seen from the evolution of the ALS in the United States the introduction of the ALS itself is not a perfect cure. Moreover, despite the fact that the ALS underlies the approach to transfer pricing control in many countries, it remains a problematic issue.

Many American scholars and practitioners believe that the developing countries should be cautious in copying blindly the traditional ALS approach, which was declared by some of its proponents as the prevailing standard for transfer pricing transaction\textsuperscript{126}. To begin with, quite possibly the ALS is not necessarily the best decision. Some commentators stated that the adoption of the ALS in the US in favor of the formulary apportionment was a mistake, which caused several decades of uncertainty\textsuperscript{127}. There are some interesting opinions that the view of the ALS as a single prevailing standard is an exaggeration. Arguably, the US proponents of “arm’s length” were determined to

\textsuperscript{125} Id.
\textsuperscript{126} See S. Langbein, \textit{supra} note 102 at 649.
internationalize" the standard, principally to provide scope for the operation of the US rules. Therefore, the spread of the ALS around the world occurred due to the pressure of the US unilateral system and the effective ALS "export campaign", and not necessarily because of the exclusive advantages of the ALS. In addition, it is worth to note that only few of the countries have developed detailed rules, similar to the US regulations. "The United States is virtually alone in its search for certainty of definition of the arm's length price, to which end it relies on the medium of lengthy and detailed regulations. The good intent is not in doubt, but the practical effect may be argued to frustrate the purpose of the whole exercise..." The majority of the countries prefer not very detailed transfer pricing legislation. They have different administrative practices and legal framework for making adjustments. And many of them are not that hostile to the fractional methods as the US tax authorities. In fact, fractional methods as opposed to the ALS were more widespread than it was presented by the ALS proponents. For example, the fractional methods were continuously used by the Netherlands, Switzerland, France, and Italy as backup methods.

Probably the absence of the applicable standard in the Russian transfer pricing law is not a big disadvantage. Just to proclaim adherence to the ALS in the legislative act does not mean to create a mechanism that is workable. Possibly, defining of standards or attaching labels is not a good idea at all. For example, the Netherlands tax legislation neither has specific transfer pricing provisions nor articulated methods of allocation of

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127 See R. Avi Yonah, supra note 40, at 159.
128 See S. Langbein, supra note 102, generally.
129 E.G. Germany in 1983 followed the US and adopted the comprehensive set of transfer pricing provisions, see supra note.102 at 653.
130 Id.
131 Id. at 649.
132 Id.
income. All disputes with regard to the transfer of price are decided by courts, which successfully apply the principle of "value in economic traffic". And the majority of disputes are resolved without litigation. Thus, even without formal definitions of standards, listing of the transfer pricing methodology, and statutory restrictions the Netherlands is the example of practical and efficient tax system. The experience of some other jurisdictions demonstrates that the functional analysis of the activities of companies-members of the group, which is pretty factual, is more productive transfer pricing strategy than the ALS based methodology.

The fact that the Tax Code did not mention the arm's length principle and did not state clearly any standard does not mean transfer pricing control will not work. The most important for Russia is to reach its major economic objectives in taxation,- to stop revenue losses. Nothing bad is in the fact that this objective can be achieved by different allocation techniques, the approach must be pragmatic and efficient. To sum it up, it is not important in which language the transfer pricing rules will be embodied and which definitions adopted. Russia can develop several standards instead of one, or introduce a variety of transfer pricing policies, which are oriented to different transfer pricing situations. For example, adoption of the consolidated tax returns for companies-members of the group could be a solution for the domestic intraenterprise transfer pricing, which is currently the focal point of the Russian tax authorities. Given the complexity of the transfer pricing practical issues and dependency on the international approaches, probably the best policy for Russian legislature and tax authorities will be to develop the

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133 J. Pagan, supra note 14, at 54
134 Id.
135 Current version of the Tax Code of Russia does not provide for consolidated tax returns.
national transfer pricing rules gradually, testing step by step the workability of the new rules in practice.

Taking into account the existing experience, probably the advance pricing agreements currently would be the best solution of the transfer pricing problem. Even if the APA is not a substitute for the workable system, it is a very logical step for the country where the lion’s share of the revenues to the budget is produced by only a dozen of major taxpayers. As the US experience demonstrates, the APA works under any transfer pricing standard adopted, and even without standards. If the Russian legislature and tax authorities made the creation of the APA basic legal framework current top priority, it would have some advantages.

First, there will be neither urgent need to create detailed regulations, which traditionally for the STS, create more problems than solve, nor to overload statutes with detailed rules. Secondly, if the APA system starts to work, it will supply additional time for tax authorities to determine whether it is necessary at all to promulgate magic definitions reflecting arm’s length prices. If the decision is taken to stay committed to the traditional ALS, experience from the APA will help to determine how flexible it must be defined in the statute. Probably, as it was suggested above, formulary apportionment or other decisions could be more suitable. Thirdly, the APA can eliminate a lot of problems for Russian MNEs and tax authorities, because at present neither STS not courts have any experience how to apply transfer pricing rules. And, finally, the introduction of the APA will give experience to the STS staff and bring some understanding whether it is necessary to send the auditors of the STS as well as judges to practical training abroad before dealing with committing transfer pricing audits and resolving disputes.
In the meantime, until the priorities to the national transfer pricing rules are not clear enough, the analysis of international trends might be helpful in determining the right direction.

4. Which Trends in the World Must be Taken into Account.

In the process of developing of its own legislation, Russia has the advantage of analyzing the situation in countries with developed transfer pricing legislation as well as international trends.

One of the important things for the Russian legislature is to admit that the main idea of the introduction of transfer pricing legislation is not only about tax evasion, but mainly about the allocation of revenues from MNEs activities between the countries. Will the STS and the Duma see their task of establishing a transfer pricing control from the angle of economic integration of national economies? Or perhaps new tax wars are coming?

The worldwide activities of the MNEs cannot be stopped. And even if the future of the ALS is not clear, Russian tax authorities must respond somehow to the actions of the tax authorities of foreign countries, taxing their MNEs’ Russian operations. In this situation reworking of double tax treaties is the most prominent field of work. There are more than fifty agreements on the avoidance of double taxation entered into between Russian and foreign countries. Seventeen of them, concluded by the USSR, predecessor of Russia, were obsolete enough and did not always reflect the modern economic reality. New double tax treaties are being prepared, some of the old ones are being renegotiated. Interestingly, all new Russian double treaties contain transfer pricing clause. Moreover, if
the transfer pricing adjustments apply by any one of the treaty country, treaties provide for the cooperation between the tax authorities of treaty countries in order to exclude the possibility of double taxation. This is an additional proof that countries have become interdependent in the regulation of the transfer pricing activities of their taxpayers.

Double taxation is aggravated by the growth of e-commerce. The unilateral measures of one country to stop the loss of revenues from the e-commerce will not work. Therefore, the understanding of the need in international cooperation and coordination of efforts in this field is required.
CHAPTER IV. CONCLUSION

The conventional ALS will probably play a lesser role in the approach to transfer pricing problem. This paper sought to show why and how this happened through the evolution of the ALS in the US, a country with the most developed transfer pricing legislation. It is evident that the development of the global economy requires new approaches to transfer pricing. Given that the US is a major player in the world economy and a country with efficient system of taxation, the analysis of the problems, concerns and changes in the US with respect to transfer pricing provides an important insight in the new approaches. The existing experience is extremely important to the countries, which have just started to develop their national legislation on transfer pricing. Practice of the emerging economies in the field of international taxation will inevitably be influenced by the policies of developed nations. Understanding of the general logic of forthcoming changes may help to prevent making wrong steps in the national approaches. The example of Russia demonstrates that, despite the strong influence of the US and the OECD, it is unlikely that all developing countries will be adopting approaches similar to those the developed economies have. This is not necessarily a good result, because the different approach to taxation of MNEs in the modern world will inevitably result in economic conflicts between nations. Thus, the main conclusion is that a question as to which approach to transfer pricing can produce better results than the ALS is no longer a question of any given government or any given national tax reform. Any standard, which may be a substitute to the ALS may be introduced and effectively applied only if the
international consensus is reached and international cooperation is provided. The debates on the applicable standards may go on, but the primary goal is clear: to achieve a fair split of profits of the MNE by means of creation of a mechanism of allocation of their income in which the main criterion will be the economic contribution of the company-member of the MNE to the taxing jurisdiction.
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