An Imprudent Proposal: The Case Against Restricting the Comparable Uncontrolled Transaction Method for U.S. Transfer Pricing

By Stephen R. Faivre

In December 2009, the Internal Revenue Service found itself on the losing end of a high-profile case regarding a taxpayer's use of the comparable uncontrolled transaction (CUT) method to evaluate cost-sharing arrangements. In *Veritas Software Corp. v. Commissioner*, the U.S. Tax Court looked at buy-in payments pursuant to a cost-sharing arrangement that a software development company made with its foreign subsidiary for the transfer of pre-existing intangible property as a way to determine whether or not the property was priced properly for tax purposes. The Tax Court found that the CUT method was the best method to price the transaction between the parent and subsidiary at arm's length, despite the IRS's arguments to the contrary. The IRS solidified its position against the decision one year later, when the agency released its Action on Decision (AOD) for *Veritas*. In its AOD, the IRS argues not only that a portion of the Tax Court's findings of fact were erroneous but also that, despite the court's criticisms of the use of an "akin to a sale theory" used in the CUT method, the IRS will continue to use this method when it "provides the most reliable measure of an arm's length result."[1] As the opposing position demonstrate, reasoned analysts may differ as to which method produces a result that more closely mirrors an arm's length transaction, but there should be no disagreement that the facts of each case are determinative of the proper method to be applied.

Recently, following the codification of the economic substance doctrine (a long-standing common law doctrine requiring that transactions have an economic purpose aside from mere tax avoidance in order to be valid) in the 2010 Health Care Reconciliation and Education Act, there have been proposals to codify fact-specific approaches to pricing methods for transferring products made in the United States, and the CUT method is one example. In September 2009, the Joint Committee on Taxation (JCT) recommended that Congress adopt legislation that would render the CUT method improper in a wide range of cases.[2] There is no reason to believe that the codification of the economic substance doctrine will produce any real change in the analysis of a transaction; in fact, Bryon Christensen, deputy tax legislative counsel for the IRS, stated that analysis as to the applicability of the doctrine to a transaction should be made as if the doctrine were still only governed by common law.[3] The same cannot be said for the JCT's proposal, which all but eliminates one method of valuating a transaction that completely changes the analysis for transactions such as the one at issue in *Veritas*. The changes raise two particularly serious concerns. (1) Does a code that restricts the use of the CUT method, particularly in a manner that renders its use universally inapplicable, conflict with the United States' standing tax treaties? (2) Does this restriction ultimately undermine the goal of replicating the result of an arm's length transaction?

Background

Transfer Pricing

Multinational corporations often have subsidiaries abroad with which the parent company engages in intercompany transactions. This is, of course, one of the great features of a corporate structure of this kind: the ability of the parent and subsidiary to make use of the other's comparative advantages. However, in order to satisfy financial reporting and tax requirements, a "transfer price" must be computed that determines how much the controlled entities (a term used to refer to two or more organizations, businesses, or trades owned or controlled directly or indirectly by the same interests) must pay for the good or service received from the other. The purpose of 26 U.S.C. § 482 is to ensure parity between taxpayers in controlled transactions and taxpayers in uncontrolled transactions. The appropriate standard for pricing the transfer is "arm's length," or market value—meaning that the payment for the transfer should be the same as an amount that would have been paid on the open market if the parent and subsidiary companies were just two uncontrolled entities. Even though the codified two-pronged test of economic substance doctrine can, for the most part, be met by any significant amount, in absolute terms, there is still a very real chance that the price is not the same at that of an arm's length transaction, which would undermine the goal of parity. For this reason, there is a need for transfer pricing regulations that require the transfers of goods and services be priced as they would be in the open market.[4]

The aim of 26 U.S.C. § 482, the statute that authorizes the IRS to propose corrections to the tax liabilities of related entities based on the result of arm's length pricing, was to make specific corrections to the distortions to the net incomes of controlled entities that result from transactions that have the effect of creating a tax advantage that is not available in an arm's length transaction.[5] Because it is meant to reflect the price that would be found in the free market, the hypothetical arm's length price is an objective standard and does not depend on any intent by the taxpayer to price the transfer inaccurately.[6] The overarching goal is to put taxpayers who control multiple entities on the same level as those who do not.

Methods

Five acceptable methods for U.S. transfer pricing are enumerated in the regulations promulgated under § 482:

- the comparable uncontrolled price method (CUP),
- the resale price method,
- the cost-plus method,
- the comparable profits method (CPM), and
- the profit split method (PSM).

These methods are generally consistent with the guidelines prescribed by the Organisation for Economic Co-operation and Development (OECD). The regulations contained in § 482 apply to transfers of both tangible property and intangible property. Tangible property is defined as assets, such as machinery, that have a physical existence and may be assigned a market value; intangible property is defined as assets, such as the knowledge resulting from research and development in the case of *Veritas*, that comes in the form of proprietary information, ideas, good will, or another nonphysical commercial asset. The proposal accepted by the Joint Committee on Taxation deals only with cases of transfers or uses of intangible property—specifically, the appropriateness of the application of the CUT method (an intangible analog of the CUP method).

Comparable Uncontrolled Transaction Method (CUT Method)

The CUT method involves making a direct price comparison between controlled transactions and transactions of reference. This method is assumed to be the most direct and reliable measure of an arm's length price as long as the reference transactions are substantially similar to the controlled transaction, meaning the reference transaction should be as close as possible to an exact comparison. The further the reference transactions are from exact comparable transactions, the less reliable the CUT method is considered to be.[7]

The IRS has two requirements for the comparability of intangible property, both of which must be satisfied for the product to be considered comparable for purposes of the CUT method. First, the intangibles must be used for similar products or processes in similar industries or markets. Second, the level of prospective profits to be made from intangibles must be similar. Even though the first requirement may be somewhat open-ended, the second is more definitive and more easily calculated. The best measurement of profit potential is a direct calculation of the net current value of the benefits to be realized (either through prospective profits or cost savings) through the use or subsequent transfer of the intangible property. (Up-front costs and capital investments should be taken into account when determining the value of these net benefits). The IRS provides eight factors by which to measure the comparability of the transactions specifically:

- the terms of the transfer, including rights and restrictions on use;
- the stage of development of the intangible, including, where necessary, any governmental approvals or authorizations;
- the rights to receive updates, revisions, or modifications of the intangible;
- the uniqueness of the property and the period for which it remains unique (often as a result of protection of intellectual property rights);
- the duration of the license or use agreement and any termination or renegotiation rights;
- the risk allocation between the parties for any economic or product liability;
- the existence and extent of any collateral transactions or ongoing business agreements between the two parties; and
- any functions, including ancillary and subsidiary services, to be performed by the parties.[8]

One reality the IRS has recognized is that the profit potential for reference transactions is not always readily available. As a result, the IRS has promulgated regulations that provide for the indirect comparison of profit potentials using the eight factors listed above, but this method may be relied upon only for transactions that have relatively small potential profits in terms of the total amount and rate of return. Another weakness with the CUT method is that, for intangible property, which is often only a component of a final asset, it can be difficult to isolate the profit that is attributable to the intangible from that of the final asset. The ability to isolate profit potential has a direct correlation to the reliability of the method; as it becomes difficult to isolate this value, it becomes less likely that the CUT method is the appropriate calculus for reaching an arm's length transfer price.[9] Even though the CUT method may be the most accurate way to reach an arm's length result, the restrictions and lack of ascertainable values for intangible property may make it difficult to apply the CUT method in practice.

The Joint Committee on Taxation's Proposal

In its proposal, the JCT states the following: "Future legislation could consider additional measures that would further ensure that the CUT method is used only where there are appropriate comparable transactions (for example, in the case of unique intangible property, an 'exact' comparable involving the same intangible), as well as endorse the present use of income-based methods (and other methods that do not rely on comparable transactions) in circumstances where comparable uncontrolled transactions are unavailable." The proposal demonstrates a widening gap in the understanding of the arm's length standard—one that leaves the current administration and the Treasury Department on one side, and taxpayers and U.S. trade partners on the other.

The OECD's Guidelines

Although U.S. taxpayers are subject to the regulations imposed by § 482, the terms of tax treaties to which the United States is a party are also relevant when determining pricing of transferred property. The Technical Explanation offered for Article 9 of the United States Model Income Tax Treaty of Nov. 15, 2006, states that "with respect to Article 9, the United States generally interprets the arm's length standard in a manner consistent with the OECD Transfer Pricing Guidelines. ... Thus, any of the methods used in [the Pricing Guidelines], including profits methods, may be used as appropriate and in accordance with [the guidelines]."[10] One example of the United States' application of the OECD's guidelines can be found in the use of IRS's best-method rule pertaining to selection of a transfer pricing method. This rule requires that the arm's length result of a controlled transaction be determined by using the method that, under the particular facts and circumstances, provides the most reliable measure of an arm's length result. If one method is subsequently shown to produce a more reliable result than another method produces, the more reliable method must be employed. The most objective basis for determining whether the results of a controlled transaction are at arm's length is provided by data based on the results of transactions between unrelated parties. Accordingly, the two most important factors to consider when determining the best method are the degree of comparability (between the controlled and uncontrolled transaction) and the quality of the data and assumptions used in the analysis.[11]

The OECD's analog to the best-method rule is the "most appropriate method rule." This rule provides that the taxpayer must select the "best estimate" of an arm's length price and recommends taking into account the respective strengths and weaknesses as well as the appropriateness of application of the methods recognized by the OECD when choosing a method.[12] The Technical Explanation of Article 9 emphasizes the harmony in which the OECD's Transfer Pricing Guidelines and § 482 were meant to operate: "This article incorporates in the Convention the arm's length principle reflected in U.S. domestic transfer pricing provision, particularly code section 482."

Treaties and Conflicts of Law

The Supremacy Clause, the widely cited second clause of Article VI of the U.S. Constitution, states that: "... Laws of the United States ... and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land, and the Judges in every State shall be bound thereby, anything in the Constitution or Laws of any State to the contrary notwithstanding." In order for treaties to take effect, the Constitution requires the U.S. Senate to ratify them.[13] As evidenced by the Supremacy Clause, treaties are on par with federal statues (Laws of the United States).[14] When reconciling the relationship between statutes and treaties, the U.S. Supreme Court tries to construe the federal statute in a manner that is consistent with the United States' treaty obligations, absent clear congressional intent to supersede those treaties.[15] When a conflict between a treaty and a federal statute is unavoidable, the one that is enacted last in time will prevail.[16] The enforceability of treaties by individual citizens and taxpayers depends on whether or not the treaty is self-executing; individuals in court may enforce only treaties that are self-executing.[17]

Discussion

Congress should not adopt the Joint Committee on Taxation's proposal, because its provisions are inconsistent with U.S. tax treaties. The JCT's proposal would have U.S. transfer pricing guidelines deviate from the OECD's, even though the OECD's guidelines were the ones contemplated in treaties and the guidelines that the United States' trade partners have generally accepted as the ones that can best produce the arm's length standard.

The Reason Courts Would Not Defer to the Treasury Department's

At first glance, the need for congressional action on a treaty may not be entirely obvious. Courts give deference to the legal interpretations of a treaty's meaning to the agency that is charged with negotiating the treaty and enforcing its terms. The U.S. Department of the Treasury could simply assert that the reliability of the CUT method is seriously diminished when exact comparables are not available and that, in cases when inexact comparables are used, the CUT method will be considered the least reliable under the best-method rule analysis. However, courts have repeatedly failed to give much weight to technical explanations of treaty obligations that are drafted unilaterally. In *Xilinx v. Commissioner*, the Ninth Circuit stated that the Technical Explanation offered for the 1997 U.S. Ireland Income Tax Treaty "does not justify disregarding the all costs requirement when determining deductible costs. A Technical Explanation is not subject to the Administrative Powers Act's notice and comment requirement and does not carry the force of law. Certainly, it cannot trump the plain language… of the regulation, which does have the force of law." *Xilinx Inc. v. Commissioner*, 598 F.3d 1191, 1200 (9th Cir. 2010).

Ambiguity

The 1997 Technical Explanation acknowledges that "[t]he implementation of [the arm's length standard] in Sec. 482 is in accordance with the principles [of this treaty] as interpreted by the OECD Transfer Pricing Guidelines." There can be little doubt that the OECD's guidelines place no bright-line restriction on the use of the CUT method when exact comparables are unavailable, but the Treasury Department's Technical Explanation states that "[it] is understood that nothing in [paragraph 1 of the treaty] limits the rights of the Contracting States to apply their internal law provisions relating to adjustments between related parties." There may be some ambiguity as to whether this provision allows for the unilateral restriction of the use of the CUT method. If the court finds this statement to have created some ambiguity, then the court will resolve this ambiguity by looking at evidence of the parties' understanding that surrounds the agreement.[18]

Contradictory Evidence

A great deal of evidence contradicts the notion that the 1997 Technical Explanation empowers either the United States or Ireland to unilaterally restrict the terms of the agreement through provisions of their internal law.

A treaty must be construed in accordance with the intent of both signatories. In *Xerox Corp. v. U.S.*, the Federal Circuit was reluctant to accept the IRS's contention that the other country acquiesces to the terms of the IRS's Technical Explanations when the country fails to object to them prior to ratification. The court stated that "it would violate any reasonable canon of construction to infer mutual assent by the signatories to the position taken by the Treasury." In addition, in cases in which courts inquire into an ambiguity such as the one presented in the 1997 Technical Explanation, assuming the nondrafter's acquiescence to terms that were unilaterally drafted and are ambiguous would greatly undermine the principle of signatory intent. In the example discussed above, for example, even if Ireland had acquiesced to the terms of the 1997 Technical Explanation, there is a great deal of evidence that its interpretation of the terms did not allow for the restriction of the CUT method.[19] A treaty partner's silence after receiving the Technical Explanation does not constitute direct evidence of an agreement on the interpretation of the terms. When there is more reliable evidence of the mutual understanding of treaty terms at the time of negotiation—the OECD Transfer Pricing Guidelines, for example—the other country's interpretation of the terms should be limited by this evidence.[20] Ireland's silent acceptance of the 1997 Technical Explanation should not be read to have been an agreement to contradict the principles of the OECD guidelines. Moreover, because the interpretation also contradicts the notes to Article 9 of the 2006 Model Treaty, which does not deviate in this respect from its 1996 predecessor, it is hard to believe that the United States even assented to the ability to restrict the CUT method in the proposed manner.

When interpreting treaties, courts have failed to give much weight to any unilaterally drafted interpretations or explanations, such as Technical Explanations or legislators' ex post facto statements. Instead, in accordance with the canons of construction, the court's inquiry has been focused on an attempt to understand the treaty as it was mutually understood by the signatories. The 1997 Technical Explanation deserves little weight, and it appears that, even if given weight, it does not support the contention that it is permissible to restrict the CUT method as proposed by the JCT.

For these reasons, and in light of the Ninth Circuit's holding in *Xilinx,* it would be necessary for Congress to enact this restriction legislatively in order for it to be upheld by the courts. As this article argues, however, such action is not advisable.

The Inconsistency of Proposed Restrictions to the CUT Method With U.S. Treaty Obligations

Tax treaties are agreements between nations that are enacted with the purpose and effect of preventing double taxation of taxpayers operating within both countries. As a result, a zero-sum game is created between the two countries for the right to tax a portion of a multinational corporation's income. The terms of the treaty represent the rules under which this zero-sum game is to operate. For example, in *Veritas*, the IRS proposed that the taxpayer be forced to make a payment of $1.675 billion from its Ireland-based subsidiary, Veritas Ireland, to its parent company based in the United States, Veritas Software Corporation, for the transfer of pre-existing intangibles—an amount almost 10 times greater than the $166 million actually paid by Veritas Ireland. The difference between these two amounts represents more than $1.5 billion of taxable income. If this income were taxable by the IRS, as it had proposed, it would represent approximately $187.5 million in lost tax revenue for the Republic of Ireland. The Tax Court found that, under the rules of the Internal Revenue Code, which reflect the agreement reached by the United States and Ireland on how transfers between controlled taxpayers are to be treated, the proposed additional income was not attributable to the parent company that is based in the United States.

Demonstrating its discontent with this outcome, the Joint

Committee on Taxation wants to make changes that all but eliminate the application of the CUT method in determining the arm's length price of a transfer. Even though the change could not be applied retroactively to recoup the income tax to which the IRS feels it was entitled in *Veritas* and even though the IRS may be presented with future transactions in which less income is taxable in the United States because the CUT method was inapplicable, the change would still be inherently unfair to the United States' trading partners. Any change that unilaterally restricts the use of the CUT method would change the rules of the game without the consent of all of the players involved. Beyond the inherent unfairness of such an action, it undermines the credibility of the United States' tax treaties and places global cooperation on taxation at risk.

The JCT proposes applying the CUT method to unique intangible property only when an "exact" comparable involving the same intangible can be found. This proposal rules out the use of inexact comparables even when the reliability of the results is properly discounted and the CUT method is still the best method under the OECD's most-appropriate-method analysis. The JCT considers the use of inexact comparables to determine an arm's length price for a unique intangible to be improper because it leaves too much room for gamesmanship on the part of the taxpayer entity. This claim may be supported by empirical evidence that suggests that multinational corporations based in the United States shift the income they earn to their subsidiaries in foreign jurisdictions that have lower tax rates—countries like Ireland—by transferring valuable intangible assets to subsidiaries based in these jurisdictions at prices that are lower than those available at arm's length. Although many factors may influence the location of investments, data shows that multinational corporations based in the United States report a greater level of accumulated earnings and profits in Ireland than in jurisdictions that have relatively high taxes—such as the Great Britain and Germany—despite the larger populations and markets in these two countries.

In addition, the JCT highlights some flaws in the application of the CUT method to value intangibles. First, taxpayers who develop high value intangibles rarely ever transfer that property to third parties, making it difficult to determine the comparable terms under which an arm's length transfer would occur. Second, economic risk does not shift when the transfer is made between controlled entities, because the multinational corporation's control over its subsidiaries allows it to reap the future profits generated by the intangible asset. The multinational corporation's equity interest in the subsidiary companies assures that it may ultimately obtain the benefit of future profits, even those that were not anticipated, regardless of the price set for the transfer.[21]

There should be no question that the Joint Committee on Taxation raises issues that may cast serious doubt over the reliability of the CUT method in replicating an arm's length result for controlled transfers of intangible property that has a high value; however, the United States must first consider its obligations to its trade partners before taking steps to restrict the application of that method. One obligation is that any method deemed acceptable by the OECD and applied in accordance with its guidelines, should also be deemed acceptable by the IRS and the courts of the United States in determining an arm's length transfer price. There seems to be an unavoidable conflict presented by placing restrictions on the CUT method that would make it virtually impossible to apply this method to high-value intangibles. This is because, in spite of courts' attempts to construe federal statutes in a way that is consistent with U.S. treaties absent clear congressional intent to supersede those treaties,[22] the OECD guidelines already give great weight to the issue of the acceptable use and reliability of various transfer pricing methods and leave no room for further restrictions on their applicability. Despite the conflict, courts and taxpayers would be forced to defer to the restriction on the use of the CUT method as it would be enacted subsequent to enactment of the treaty.[23]

Unlike cases in which the Treasury Department's guidance conflicts with the terms of a treaty, taxpayers will have no recourse on the basis of the statute conflicting with U.S. treaty obligations because the provisions of the tax treaties are not self-executing.[24] (This is not the case in the scenario in which IRS guidance or a treaty's Technical Explanations conflict with a more reasonable interpretation of a treaty.) In *Medellín v. Texas*, the U.S. Supreme Court held that treaties are not binding domestic law unless they are implemented by legislation or are self-executing. Since the legislation proposed would necessarily conflict with the treaty, the treaty would need to be self-executing in order for its provisions to be enforceable by individual taxpayers. However, because tax treaties require implementation by legislature of parallel tax provisions in order to have any meaning for a taxpayer, these treaties are not self-executing and they grant no right of private action to taxpayers. The taxpayer is bound by the federal statutes found in the Internal Revenue Code at 26 U.S.C.

An issue of greater concern involves the global implications resulting from the United States' failure to honor the commitments made in its tax treaties. Countries are obliged to refrain from acts that would defeat the object and purpose of the treaty. Moreover, a party to a treaty may not invoke the provisions of its domestic law as justification for not abiding by the terms of a treaty. A material breach, or a breach that violates a provision essential to the object or purpose of the treaty, entitles the party affected by the breach to invoke it as grounds for suspension or termination of the treaty.[25] The purpose of the tax treaties of the United States is clear: to avoid double taxation and to prevent fiscal evasion with respect to taxes on income and capital gains. The way to achieve this purpose is through the agreed-upon terms that are the result of a consensus between the two nations. In almost all tax treaties to which the United States finds itself a partner, this consensus is normally to give deference to the OECD Transfer Pricing Guidelines in matters regarding methods used to determine the pricing of transferred property.

The United States commits a material breach of the terms of a treaty if it follows the JCT's suggestions and passes legislation that places further restrictions on the CUT method. For this reason, any country that has a treaty with the United States that is breached by the United States is within its rights to dissolve or suspend all provisions of its tax treaty with the United States.[26] The United States will find little support or sympathy if it were to make a case to the international community that a material breach has not been committed, and there are two reasons for this reaction. First, the OECD is made up of 34 member nations, all of which have entered into tax treaties with the United States. Second, the restrictions on the use of the CUT method have only one underlying purpose: to increase the taxable income pool of the United States. However, the zero-sum nature of this income, which is created by the agreements to avoid double taxation, means that any increase in multinational corporations' U.S. taxable income is a decrease in another nation's taxable income of these entities. Because the United States currently has one of the highest corporate tax rates in the world,[27] it would normally be irrational for a multinational corporation to make a meritless claim that income should be attributed to its partner based in the United States rather than to the one based in a foreign country. Absent the many external international relations factors that may play into a country's decision to acknowledge the material breach of a treaty—a necessary element to avoid giving implicit consent to changes in the United States' interpretation of its obligation[28]—there appears to be no reason for another country to acquiesce to the United States' newly found interpretation of its obligation, especially when that step is taken directly at that country's expense.

Breaching tax treaties would ultimately do a great deal of harm to the United States, which finds itself at a competitive disadvantage in terms of its corporate tax rate. Therefore, the United States has a much greater interest in preventing fiscal evasion of tax liability than almost any other country with which it enters into a tax treaty. If the treaties are deemed void, many of the protections against international tax evasion that are built into them will no longer be available to the United States. The tax revenue lost as a result of failure to cooperate is likely to be greater than any tax revenue to which the IRS believes it is currently entitled—as was the case in *Veritas*. Even worse is the damage to the credibility of agreements entered into by the United States, which is an underlying necessity for remaining an economic and political hegemon. By adopting the proposed restrictions to the CUT method the United States would be, in effect, cutting off its nose to spite its face.

The JCT Proposal vs. the Best Method Principle and the Arm's Length Standard Espoused by § 482.

The most effective way to reach an arm's length result is to select the transfer pricing method that is most appropriate for the particular case at hand. No single method can be considered the most suitable for every possible scenario, and it is not necessary to prove that a particular method is not suitable under certain circumstances.[29] These are the principles that comprise the best method rule of § 482. These principles run in stark contrast to the bright-line rule promoted by the Joint Committee on Taxation: that data from uncontrolled transactions cannot be used if the comparables are not exactly similar to those of the controlled transaction. Both the OECD and § 482 recognize that the reliability of traditional transactional methods such as the CUT method must be discounted for comparability (or lack thereof).[30] Useful information that can be derived from uncontrolled transactions should not be completely disregarded in favor of another method just because the comparables do not meet an arbitrary standard of exactness. Instead, as is the current state of transfer pricing requirements in the United States, a taxpayer should be forced to show why the method chosen to determine pricing provides the most reliable replica of an uncontrolled transaction price. If the IRS can successfully show that one method is more reliable than a method relied upon by the taxpayer, a court will apply the more reliable method.[31]

In its Action on Decision, the IRS claimed that the Tax Court erred in concluding that the CUT method was the best method to determine an arm's length result, given the circumstances surrounding the *Veritas* transaction. The IRS's main argument in the AOD is that factual findings made by the Tax Court were erroneous. Although the IRS is certainly entitled to make this claim and therefore refrain from acquiescing to the decision, cases such as this cannot justify the response suggested by the JCT, which would undermine the best method principle and thus the arm's length standard. The AOD makes no claim that the Tax Court erred by applying the CUT method to a case involving the transfer of high-value intangibles but only that the Tax Court's finding that the CUT method was the best method for reaching an arm's length transaction was the result of erroneous findings of fact.[32] Thus, it logically follows from the AOD that the IRS recognizes that there are circumstances in which the CUT method provides the best measure of an arm's length transaction involving inexact comparables with high-value intangibles, but that these circumstances were not present in *Veritas*.

By eliminating the use of the CUT method when exact comparables are unavailable, the JCT's proposal essentially eliminates the choice of a best method and leaves only the profit split method available. Because of its reliance on comparable transactions to determine the profit margins of the unrelated entities, the comparable profits method is rejected for the same reason the CUT method is found unreliable. In addition, because economic risks are not shifted in controlled transactions and because the CPM is not reliable when it comes to data related to profit margins, the CPM tends to be inapplicable for determining pricing of valuable intangible property that is transferred. Section 482 recognizes these problems and states that the tested party used in the CPM analysis should not be a party that owns valuable intangible property that distinguishes it from an uncontrolled taxpayer, essentially excluding the CPM in cases such as *Veritas*.

The profit split method is not without its flaws when it comes to determining pricing of high-value intangibles, because the PSM is assumed to be less reliable than both the CUT method and the CPM. In addition, it may be difficult to measure combined revenue and costs for all of the related entities participating in the controlled transaction because it would require starting books and records on a common basis and making adjustments to accounting practices and currencies. Also, when the PSM is applied to the operating profit of an entity, it may be difficult to determine how the operating expenses should be allocated between the transaction and the entity's other activities.[33] This may be even more difficult in the case of high-value intangibles when the technology and intellectual property developed may be used for various business ventures.

It should be noted that the transfer prices for unique intangible property must be "commensurate with the income attributable to the intangible." This rule allows the IRS to require annual adjustment of the transfer price to reflect unanticipated changes in the income the intangible property generates, as long as that income is outside of a 20 percent margin of error for the profits anticipated at the time the parties entered into the agreement.[34]

The JCT's elimination of the CUT method when exact comparables are unavailable undermines the principles behind the best method rule and virtually eliminates the use of the rule for controlled transactions involving the transfer of high-value intangibles. In doing so, the JCT compromises the reliability that the resulting transfer price reflects an arm's length standard in such transactions. Moreover, when one considers the protection afforded to the IRS as a result of the "commensurate with income" rule, the case that the JCT's proposed rules are necessary to protect the IRS from abusive use of the CUT method is weakened.

Conclusion

Even though the Joint Committee on Taxation highlights some real problems that exist in the practice of pricing property that is transferred—specifically regarding the use of the CUT method for unique high-value intangibles—the JCT's proposal is an overreaction to the current situation. By adopting the proposal, the United States would find itself in the awkward position of needing to explain its breach of international agreements with many nations. In addition, U.S. transfer pricing guidelines would be at odds with the widely accepted guidelines prescribed by the Organisation for Economic Co-operation and Development.

The proper protocol would be for the United States to present the JCT's proposal to the OECD and its member nations, but it is unlikely they would be persuaded by the JCT report. The cynical view is that, despite the merits of the JCT's proposal, the zero-sum nature of taxable income discourages the international community from adopting any rules that are bound to increase the amount of taxable income for a country that has a high tax rate, such as the United States, and thus decrease the amount of income taxable elsewhere. A more in-depth view reveals that the JCT's proposal undermines the best method rule and ultimately the arm's length standard—a standard that reflects the entire purpose of transfer pricing. Consequently, it would not be prudent for the United States to adopt the Joint Committee on Taxation's proposal to limit the use of the comparable uncontrolled transaction method to cases in which only exact comparable values are available. **TFL**

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Endnotes

[1]*See Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (U.S. Tax. Ct. 2009); *see* Internal Revenue Service, *Veritas*, Action on Decision, 2010-05 (Dec. 6, 2010).

[2]Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment*, JCS-4-09 (Sept. 14, 2009).

[3]John Herzfeld, *Codification of Economic Substance No Common Law Change, IRS Official Says*, 19 Tax Mgmt. (BNA Transfer Pricing Report) 739 (Nov. 4, 2010).

[4]Robert E. Meldman and Michael Schadewald, A Practical Guide to U.S. Taxation of International Transactions 119, (3d ed. 2000).

[5]*Northwestern Nat. Bank of Minneapolis v. U.S.*, 556 F.2d. 889 (8th Cir. 1977).

[6]*U.S. Steel Corp. v. Commissioner*, 617 F.2d 74 (2d Cir. 1980).

[7]Jens Wittendorff, Transfer Pricing and the Arm's Length Principle in International Tax Law 649–651 (2010).

[8]U.S. Department of the Treasury, Reg. § 1.482-4(c)(iii)(B) (1986).

[9]Wittendorff, *supra* note 7, at 650.

[10]United States Model Income Tax Convention, Art. 7 (Nov. 15, 2006).

[11]Dept. of the Treasury, *supra* note 8, § 1.482-1(c).

[12]Organisation for Economic Co-operation and Development, Centre for Tax Policy and Administration, *Transfer Pricing Methods* (July 22, 2010), available at www.oecd.org/dataoecd/41/7/45765701.pdf.

[13]U.S. Const. art. VI, cl. 2; U.S. Const. art. II, § 2, cl. 2.

[14]*Id*.

[15]*Weinberger v. Rossi*, 456 U.S. 25 (1982).

[16]*Breard v. Greene*, 523 U.S. 371 (1998).

[17]*Medellín v. Texas*, 552 U.S. 491, 494 (2008).

[18]Michael S. Kirsch, *The Limits of Administrative Guidance in the Interpretation of Tax Treaties*, 87 Tex. L. Rev. 1063 (2009).

[19]*Xerox Corp. v. U.S.*, 41 F.3d at 656 (Fed. Cir. 1994).

[20]Kirsch, *supra* note 18.

[21]JCT, *supra* note 2.

[22]*Weinberger*, *supra* note 15, at 32.

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sion. Tapia now appeals to the U.S. Supreme Court, contending that the plain meaning and legislative history of the Sentencing Reform Act confirm that rehabilitation is an inappropriate consideration in prison sentencing. The United States agrees with Tapia and urges vacating the lower court decision. Writing as amicus curiae by invitation of the Supreme Court, Professor Stephanos Bibas asserts that district courts may properly consider the rehabilitative potential of in-prison targeted treatment programs when determining a prison sentence. Full text is available at topics.law.cornell.edu/supct/cert/10-5400. **TFL**

Prepared by Jacqueline Bendert and Rachel Sparks Bradley. Edited by Kate Hajjar.

United States v. Jicarilla Apache Nation (10-382)

Appealed from the U.S. Court of Appeals for the Federal Circuit (Feb. 1, 2010)
Oral argument: April 20, 2011

In 2002, the Jicarilla Apache Nation filed a breach of trust action against the United States, alleging mismanagement of funds held in trust for the tribe. In 2008, the Jicarilla Apache Nation moved to compel the production of a few hundred documents exchanged between the government and its attorneys, but the government refused to disclose nearly 160 documents on the grounds of attorney-client privilege. The Court of Federal Claims subsequently granted Jicarilla's motion to compel production of the documents, and the Federal Circuit affirmed. Now, the United States argues that disclosure of the documents was unwarranted, because no statute or regulation specifically requires the disclosure. The Jicarilla Apache Nation, however, contends that the government must be treated like an ordinary private trustee and forced to disclose information exchanged with its attorneys. Full text is available at topics.law.cornell.edu/supct/cert/10-382. **TFL**

Prepared by Colin O'Regan and Edan Shertzer. Edited by Joanna Chen.

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[100]*Id.* § 501(r)(5).
[101]*Id.* § 501(r)(6).
[102]Fine and Jedry, *supra* note 5, at 6.
[103]King et al., *supra* note 27, at 11–13.
[104]ACA, *supra* note 29, § 501(r)(2)(B).
[105]Fine and Jedry, *supra* note 5, at 7.
[106]ACA, *supra* note 29, § 501(r)(2)(A).
[107]Stewart and Azman, *supra* note 94, at 12.
[108]*Id.*
[109]*Id.*
[110]Fine and Jedry, *supra* note 5, at 7.
[111]Stewart and Azman, *supra* note 94, at 15.
[112]*Id.*
[113]IRS, Rev. Rul., *supra* note 20.
[114]Stewart and Azman, *supra* note 94, at 15.
[115]*Id.* at 16.
[116]*Id.* at 17.
[117]*Id.*
[118]*Id.* at 16.
[119]*IRS Exempt Organizations (TE/GE), Hospital Compliance Project Final Report*, *supra* note 24, at 169, 171.

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[23]*Breard*, *supra* note 16, at 194.
[24]*Medellín*, *supra* note 17, at 494.
[25]Vienna Convention of the Law on Treaties, 1155 U.N.T.S. 331 (May 23, 1969).
[26]*See Convention Between the Government of the United States and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and Capital Gains*, *U.S.-Ireland*, Jul. 28, 1997. A list of links to all U.S. tax treaties is provided by the IRS and is available at www.irs.gov/businesses/international/article/0,,id=96739,00.html. The OECD's list of member countries is available at www.oecd.org/countrieslist/0,3025,en_33873108_33844430_1_1_1_1_1,00.html.
[27]*See* Congress of the United States, Congressional Budget Office, *Corporate Tax Rates: International Comparisons*, Nov. 2005 (Ireland has one of the world's lowest corporate tax rates at 12.5 percent on nontrading income.).
[28]Vienna Convention on the Law of Treaties, *supra* note 24.
[29]Organisation for Economic Co-Operation and Development, Centre for Tax Policy and Administration, *Proposed Revision of Chapters I-III of the Transfer Pricing Guidelines* (Jan. 9, 2010), available at www.oecd.org/dataoecd/1/57/43655703/pdf.
[30]*See* OECD, *supra*, note 12; *See* Wittendorff, *supra* note 7, at 650.
[31]*Veritas*, *supra* note 1, at 327.
[32]*Veritas*, *supra* note 1.
[33]Wittendorff, *supra*, note 7 at 655–656; Dept. of Treas., Reg. § 1.482-5(b)(2)(i).
[34]*Id.*, § 1.482-4(f)(2)(i).