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The White Paper: The Stealth Bomber of the Section 482 Arsenal

Josh O. Ungerman

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AUTHORIZED by an extremely broad and ambiguous statute, the
government holds the power to reallocate the tax benefits and bur-
dens of two related entities in order to reflect clearly their respective
incomes.¹ Section 482 of the Internal Revenue Code vests this power in the
Commissioner of the Internal Revenue Service.² The exercise of this power
may potentially affect both domestic and multinational companies.³ Domesti-
corporations may feel at the mercy of a Commissioner whose adjustment
to their tax liability could potentially create devastating effects. On an in-
ternational scale, the problem manifests itself in two ways: corporations not
only may face the possibility of paying an additional unplanned tax to the
United States Government, but also must comply with the demands of their
own country’s taxing authority. The magnitude and effect of adjustments
under section 482 appear to have few or no boundaries.⁴ Consider the fol-
lowing hypothetical situation.

The doctors and scientists at the Research and Development Laboratories
of DowJohn Company realize that the side effect of one of their products

1. Section 482 of the Internal Revenue Code provides:
   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 busi-
   nesses, if he determines that such distribution, apportionment, or allocation is
   necessary in order to prevent evasion of taxes or clearly to reflect the income of
   any of such organizations, trades, or businesses. In the case of any transfer (or
   license) of intangible property (within the meaning of section 936(h)(3)(B)), the
   income with respect to such transfer or license shall be commensurate with the
   income attributable to the intangible.

I.R.C. § 482 (1986).
2. Section 482 specifically gives the Secretary of the Treasury the authority to reallocate
   income, deductions, credits, and allowances, but § 7802(c) authorizes the Secretary to assign
   powers and duties to the Commissioner of the Internal Revenue. Id. § 7802(a).
3. Section 482 parenthetically refers to business entities “whether or not incorporated
   . . . in the United States.” Id. § 482.
4. See, e.g., Eli Lilly & Co. v. Commissioner, 84 T.C. 966 (1985), aff’d in part, rev’d in
   part, 88-2 Stand. Fed. Tax Rep. (CCH) ¶ 9502 (7th Cir. 1988) (IRS assessed Eli Lilly total
deficiency of $34,220,347 based on § 482 adjustments for tax years 1971 through 1973); Hospi-
tal Corp. of Am. v. Commissioner, 81 T.C. 520 (1983) (IRS made § 482-related assessments of
$29,187,645); PPG Indus., Inc. v. Commissioner, 55 T.C. 928 (1970) (IRS assessed $5,495,389
in additional taxes pursuant to § 482 adjustments).
will prevent and possibly restore human hair loss. Recognizing the market potential for DowJohn's hair treatment product, DowJohn immediately engages in an aggressive marketing strategy. Next, DowJohn creates a manufacturing subsidiary in Puerto Rico, DowJohn P.R., responsible for manufacturing the hair loss formula. DowJohn subsequently transfers the hair formula patents and know-how to DowJohn P.R. in exchange for DowJohn P.R.'s stock.

The heads of DowJohn and DowJohn P.R. negotiate and arrive at a price for which DowJohn P.R. agrees to sell the finished product to DowJohn. The price at which DowJohn P.R. sells the product to DowJohn is known as the transfer price. As anticipated, the product enjoys much success.

Three years later, the Internal Revenue Service examines DowJohn's operations and concludes that DowJohn P.R. must reduce the transfer price, thereby causing DowJohn to realize more profits from the resale of the product. DowJohn enters into a written agreement for a new transfer price formula with the Service, even though the agreement will increase DowJohn's taxes by millions of dollars per year.

DowJohn continues to apply the agreed formula to determine the transfer price for the next few years, until the Service expresses renewed dissatisfaction with the intercorporate transactions. Due to competitors' independent development of the formula used in DowJohn's patent, the Service concludes that DowJohn's transfer price, once again, does not clearly reflect the proper income of the entire company. Consequently, the Service recomputes the transfer price using a different formula. The government's "new" transfer price has the same effect as the previous transfer price in that DowJohn incurs an onerous tax liability.

DowJohn's theoretical situation represents more than the abstract scenario that appears in the nightmares of large corporations' presidents. DowJohn's situation represents the seemingly unlimited power granted to the Commissioner of the Internal Revenue Service in section 482, "Allocation of Income and Deductions Among Taxpayers." Section 482 of the Internal Revenue Code grants the Secretary of the Treasury the power to allocate income, deductions, credits, or allowances among controlled taxpayers; the Secretary's reallocation must prevent the evasion of taxes or distortion of income between two controlled organizations. In response to congressional pressures, the Treasury Department promulgated regulations in 1968 covering section 482. The 1968 regulations apply to tangible and intangible property. Even after the Treasury issued the 1968 regulations, Congress felt that section 482 failed in its goals of preventing evasion of taxes and distinction of income with regard to transfers of intangibles be-

6. Id.
8. See Treas. Regs. §§ 1.482-1(d) to -2(e) (1968).
9. See id. § 1.482-2(c) (use of tangible property), § 1.482-2(d) (transfer or use of intangible property), § 1.482-2(e) (sales of tangible property).
between related parties. Moreover, Congress felt that the "arm's length" rules incorporated in the 1968 regulations resulted in an unfair allocation of income among related taxpayers. Consequently, the Tax Reform Act of 1986 (TRA of 1986) included an amendment to section 482 requiring that payments pursuant to the transfer or license of intangible property be commensurate with income attributable to the intangible. The 1986 amendment to section 482 is commonly referred to as the "super royalty provision." The Conference Committee Report dealing with the super royalty provision also called for a comprehensive study of intercompany pricing by the Internal Revenue Service. The discussion draft of this study, also known as the "Section 482 White Paper," ultimately appeared in the latter part of 1988.

This Comment analyzes the problems associated with section 482 and the new super royalty provision and evaluates the White Paper's recommended treatment of these problems. Specifically, the Comment examines the history of section 482, including the section's necessity in relation to the recent general economic climate in the United States. The Comment next identifies limits of the broad power authorized by section 482, particularly with regard to various judicial and treaty interpretations of section 482. An analysis of the super royalty provision follows, including the White Paper's responses. Finally, an inquiry probes the impacts of the super royalty provision in light of the present economic conditions of the United States as a world power.

I. OVERSEEING INTERCORPORATE TAX MANIPULATIONS: THE HISTORICAL DEVELOPMENT OF SECTION 482

A. From Consolidation to Allocation

The legislature responded to potential pricing abuses in the War Revenue Act of 1917 by requiring every corporation to supply the Commissioner of the Internal Revenue Service with information describing its relations with other affiliated corporations. The Commissioner required corporations to

14. The term "super royalty" refers to the situation in which a licensor of royalties enjoys extraordinarily high royalty payments. The super royalty provision ensures the allocation of royalty payments between the licensor and the licensee to reflect the proper amount of the royalty income attributable to each party. See Looman, Symons, Patrick & Simpson, San Francisco Roundtable Discusses the "Super Royalty" and Other Transfer Pricing Issues Affecting Intangibles, Int'l Tax Rev., July/Aug. 1988, at 1 [hereinafter Looman].
file consolidated tax returns to properly "determine" income.\textsuperscript{18} The Revenue Act of 1921 vested the Commissioner with the direct power to prepare consolidated tax returns in order to reflect the taxpayer's "accurate" income.\textsuperscript{19} Seven years later Congress enacted the Revenue Act of 1928, which included section 45, labeled "Allocation of Income and Deductions."\textsuperscript{20} With section 45 Congress went beyond the narrow scope of the consolidated return provisions of prior revenue acts into the broader area of allocation of income and deductions.\textsuperscript{21} The legislative history provided the Commissioner with authority to make allocations necessary in order to prevent tax evasion and to reflect clearly the "true" tax liability of commonly controlled businesses.\textsuperscript{22}

The early regulations and case law arising under section 45 of the Revenue Act of 1928 established the statutory underpinnings of section 482.\textsuperscript{23} Treasury regulations issued in 1935 provided another cornerstone in the development of section 482 with the mandated use of an arm's length standard.\textsuperscript{24} The regulations required that taxpayers treat their transactions, in all cases, as if the negotiations involved uncontrolled taxpayers dealing at arm's length.\textsuperscript{25} The 1935 regulations did not define the term "uncontrolled tax-

\textsuperscript{18} Regulation 41, art. 78, War Revenue Act of 1917.
\textsuperscript{19} Revenue Act of 1921, ch. 136, § 240(d), 42 Stat. 260 (1921).
\textsuperscript{20} Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806 (1928).
\textsuperscript{21} While § 240(d) of the Revenue Act of 1921 stated that "the Commissioner may consolidate the accounts of . . . related trades and businesses," § 45 of the 1928 Act provided that "the Commissioner is authorized to . . . allocate gross income . . . among such trades or businesses . . . ." See statutes cited supra notes 19, 20.
\textsuperscript{22} The report from the House Ways and Means Committee on the Revenue Bill of 1928 stated that "the Commissioner may . . . apportion, allocate or distribute the income or deductions . . . in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods adopted for the purpose of "milking"), and in order clearly to reflect . . . true tax liability." H.R. REP. No. 2, 70th Cong., 1st Sess. 16-17 (1928).
\textsuperscript{23} The following statutes reflect almost identical terminology: Section 45 of the Code states:

\begin{quote}
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 Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
\end{quote}

I.R.C. § 45 (1939). Section 482 of the Code states:

\begin{quote}
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 of such organizations, trades, or businesses.
\end{quote}


\textsuperscript{24} Treas. Regs. 86, § 45-1(b) (1935). "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." \textit{Id}.
\textsuperscript{25} \textit{Id}.
payers," but implied that it meant two or more organizations, trades, or businesses with no common interests.\textsuperscript{26}

The cases arising under section 45 interpreted the Code section broadly.\textsuperscript{27} As early as 1935, \textit{Asiatic Petroleum Co. v. Commissioner}\textsuperscript{28} held that the phrase "evasion of taxes" in section 45 reached broadly enough to include the avoidance of realization of income through the transfer of profits by subsidiary corporations. The court further held that section 45 applied to tax avoidance by a subsidiary of either a foreign or domestic parent.\textsuperscript{29} \textit{Central Cuba Sugar Co. v. Commissioner},\textsuperscript{30} decided in 1952, allowed reallocation of operating expense deductions without inquiry into the possibility of tax evasion by Central Cuba Sugar Company. The court interpreted section 45 as not requiring the Internal Revenue Service actually to prove tax evasion in order to apply section 45.\textsuperscript{31}

\textbf{B. 1968 Section 482 Regulations: Determining an Arm's Length Price}

Although the Treasury released a short set of regulations in 1962 that described the scope and application of section 482,\textsuperscript{32} the House and Senate debated the issue of amending the Code section itself during that same year.\textsuperscript{33} The House sought to add a subsection (b) to section 482.\textsuperscript{34} The proposed subsection would have assigned the Secretary of the Treasury the role of allocating taxable income among related entities, including foreign corporations.\textsuperscript{35} The allocated income was to be based on the revenue generated by the sale of tangible property between the members of the group.\textsuperscript{36} The Senate, however, eventually convinced the House that the allocation objective could best be accomplished through additional regulations promulgated by the Treasury.\textsuperscript{37}

\begin{itemize}
\item \textsuperscript{26} Id. § 45-1(a)(4).
\item \textsuperscript{27} See White Paper, supra note 16, at 7.
\item \textsuperscript{28} 79 F.2d 234, 237 (2d Cir.), cert. denied, 296 U.S. 645 (1935).
\item \textsuperscript{29} Id. \textit{Asiatic Petroleum} demonstrated the awesome power inherent in § 45, the forerunner of § 482. The application of § 45 to multinational business entities foreshadowed the direction and emphasis of Congress's transfer pricing regime. Traditionally, the committee reports explaining § 45 refer to foreign subsidiaries "milking" U.S. parent corporations. The Second Circuit held that § 45 also applied to situations involving foreign parent corporations.\textsuperscript{37} The allocated income was to be based on the revenue generated by the sale of tangible property between the members of the group.\textsuperscript{36}
\item \textsuperscript{30} 198 F.2d 214, 215 (2d Cir.), cert. denied, 344 U.S. 874 (1952).
\item \textsuperscript{31} Id.
\item \textsuperscript{32} Treas. Reg. § 1.482-1(a) to -1(c) (1962).
\item \textsuperscript{33} See infra notes 34-37.
\item \textsuperscript{34} H.R. REP. NO. 1447, 87 Cong., 2d Sess. 28, 29 (1962).
\item \textsuperscript{35} Id.
\item \textsuperscript{36} Id. The committee report stipulated that the allocation rule was generally discretionary, but that it would not apply when the taxpayer could establish an arm's length price for the goods in question. Id. Although the report described an allocation process based on the proportion of assets, employee compensation, and promotional expenses attributable to U.S. versus non-U.S. sales, the report also sanctioned the taxpayer and the Secretary "work[ing] out some other mutually agreeable method." Id.
\item \textsuperscript{37} See supra note 7 and accompanying text. The Senate stated:
\item Section 482 already contains broad authority to the Secretary of the Treasury or his delegate to allocate income and deductions. It is believed that the Treasury should explore the possibility of developing and promulgating regulations under
\end{itemize}
The Treasury acted on Congress’s recommendations and ultimately issued additional section 482 regulations in 1968. The 1968 regulations substantially increased the volume of statutory material relating to section 482. While the earlier regulations established the basic ideas of the section’s application to international transactions and the concept of measuring all transactions on an arm’s length basis, the 1968 regulations expanded these key ideas and laid down the framework for dealing with specific types of transactions.

The 1968 regulations, most of which remain in effect and unchanged since issuance, provide guidance on the transfer or sale of services, tangible property, and intangible property. The regulations mandate allocations in the event that the amount charged for a service differs from an arm’s length charge. An arm’s length charge for services theoretically equals the amount independently charged for the same or similar services among unrelated parties in similar circumstances. The regulations state, however, that generally the arm’s length charge is deemed to be equal to the costs or deductions incurred by the members with respect to the services.

The regulations guiding the determination of an arm’s length price for the sale of tangible property between commonly controlled companies provide a complex hierarchy of methods. To convert a “controlled sale” price to an arm’s length price, the regulations offer four methods: (1) the Comparable Uncontrolled Price Method; (2) the Resale Price Method; (3) the Cost Plus Method; and (4) an unspecified “fourth method.” The regulations require the taxpayer to attempt to apply the methods in sequence beginning with the Comparable Uncontrolled Price Method. If the factors

38. See Treas. Reg. § 1.482-1(d) to -2(e) (1968).
39. See supra note 9. Regulation § 1.482-2(a) deals with loans or advances made between members of a group of controlled entities and the determination of appropriate arm’s length interest rates. Treas. Reg. § 1.482-2(a) (1968); see id. § 1.482-1(a)(1) to -1(a)(6)-(7) (defining terms under § 1.482-2).
41. § 1.482-2(b)(3).
42. Id.
43. See § 1.482-2(e)(1) to -2(e)(4).
44. The regulations define a “controlled sale” as a sale “[w]here one member of a group of controlled entities . . . sells or otherwise disposes of tangible property to another member of such group . . . at other than an arm’s length price . . . .” § 1.482-2(e)(1)(i).
45. § 1.482-2(e)(2).
46. Despite the fact that the regulations restrict the “methods” approach of price allocation exclusively to the subsection titled “Sales of Tangible Assets,” the courts have consistently applied this concept in the area of intercompany use or transfer of intangible assets. The regulations that deal with intangibles, however, simply apply “factors” to consider in price allocation. They fail to mention a methods approach. Revenue Procedure 63-10 could conceivably be interpreted as sanctioning the methods approach to intangibles’ price allocation since it describes intangibles in terms of their sale-price impact on “products.” See Rev. Proc. 63-10, 1963-1 C.B. 490, 495-96.
47. § 1.482-2(e)(3).
48. § 1.482-2(e)(4).
49. § 1.482-2(e)(1)(ii).
necessary to apply a particular method are unavailable or undeterminable, the taxpayer tries the next method. As a last resort, the regulations permit the use of a "fourth method," which amounts to any alternative method that satisfies the basic objectives of the regulations.\(^5\)

The 1968 regulations also address the issue of companies under common control using or transferring intangible property.\(^5\) As with services and tangible property, the regulations authorize the Service to reallocate costs when related parties fail to charge an arm's length price for the purchase or use of an intangible.\(^5\) The regulations define intangibles broadly, listing patents, processes, copyrights, artistic compositions, trademarks, franchises, licenses, methods, technical data, and other similar items.\(^5\)

In determining what constitutes "arm's length consideration" for the transfer or use of intangibles, the Service applies the standard test: the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances.\(^5\) In the absence of comparative unrelated party transactions, the regulations provide twelve factors designed to assist in arriving at an arm's length price.\(^5\) Thus while the Service applies a cost-oriented "methods" approach to the sale of tangibles, the

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\(^5\) 50. § 1.482-2(e)(1)(iv). Treasury Regulation § 1.482-2(c) deals with the use (as opposed to sale) of tangible property. See § 1.482-2(c)(1). The Service generally makes allocations to reflect an arm's length charge on the basis of the amount of time the respective entities used the asset. See § 1.482-2(c)(2).

\(^5\) 51. See § 1.482-2(d).

\(^5\) 52. § 1.482-2(d)(1).

\(^5\) 53. The regulations' complete list of intangibles includes:

(a) Patents, inventions, formulas, processes, designs, patterns, and other similar items;

(b) Copyrights, literary, musical, or artistic compositions, and other similar items;

(c) Trademarks, trade names, brand names, and other similar items;

(d) Franchises, licenses, contracts, and other similar items;

(e) Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, technical data, and other similar items.

§ 1.482-2(d)(3).

\(^5\) 54. § 1.482-2(d)(2)(ii).

\(^5\) 55. In determining an arm's length price, the Service inquires into:

(1) prevailing rates in the same industry for the same property;

(2) offers of competing transferors or bids of competing transferees;

(3) terms of a transfer, including geographic areas covered exclusively and rights granted;

(4) uniqueness of property and life-span of that uniqueness;

(5) protection (degree and duration) to property available under laws of the relevant countries;

(6) value of services provided by the transferor to the transferee;

(7) transferee's prospective profits or cost savings from the use or subsequent transfer of the property;

(8) transferee's investment and start-up costs;

(9) availability of substitutes for the transferred property;

(10) arm's length rates and prices determined by unrelated parties in a resale or sub-licensing arrangement;

(11) costs borne by the transferor in the development of the property; and

(12) any other fact or circumstance that unrelated parties would be likely to consider in determining the arm's length transfer value of the property.

§ 1.482-2(d)(2)(iii).
government simply stipulates relevant “factors” when focusing on the arm’s length price of intangibles.56

C. The Court’s Role in Defining “Arm’s Length”

After the Service implemented the section 482 regulations, companies attempted to put the Treasury’s methods into practice. In light of the complexities of the regulations, however, IRS agents inevitably concluded that some taxpayers had incorrectly applied section 482. Many corporations, faced with the broad power of the Service in the transfer pricing area, opted to settle with the government.57 Other companies, however, refused to accept the Service’s section 482 reallocations and turned to the judiciary. Predictably, the Treasury Department viewed some of the courts decisions as reflecting too much bias in favor of the taxpayer.58 On the other hand, the cases represent the judiciary’s limit on the broad power vested in the Service in the transfer pricing area.

_Eli Lilly & Co. v. Commissioner_59 represents the type of situation over which the IRS felt dissatisfied.60 Lilly developed and patented two manufacturing intangibles, Darvon and Darvon-N. Lilly subsequently deducted research and development costs in accordance with the appropriate Code sections.61 Next, Lilly made a section 351 tax-free transfer of the patents and manufacturing know-how to its subsidiary, a Puerto Rican possession corporation.62 The subsidiary manufactured Darvon and Darvon-N in Puerto Rico and sold the drugs to Lilly for resale to wholesalers in the United States.63 Lilly had effectively shifted the income associated with the intangibles outside of the United States tax base, to which the IRS protested.64 Lilly enjoyed the benefits of massive research and development deductions65 without experiencing the burden of a tax on the intangible’s profit.66 The Service argued for the allocation to Lilly of the profits derived from the intangibles, regardless of the tax-free transfer to Lilly’s possession subsidiary.67 The Service further contended that no comparable transactions existed.68 The Tax Court accepted only parts of the government’s argument. Upon

56. _Compare_ § 1.482-2(c)(1)(ii) (identifying the various methods used for determining an arm’s length price for the sale of tangible property among members of a controlled group) _with_ § 1.482-2(d)(2)(iii) (listing factors relevant to determine an arm’s length price for transfer or use of intangibles).


58. _See_ Looman, _supra_ note 14, at 2 (describing decisions as “ad hoc” and “arbitrary”).


60. Looman, _supra_ note 14, at 2.

61. _Eli Lilly_, 84 T.C. at 1062-63.

62. _Id._ at 1113-14.

63. _Id._ at 1052.


65. _Eli Lilly_, 84 T.C. at 1062.

66. _Id._ at 1133.

67. _Id._ at 1125.

68. _Id._ at 1134-35.
finding no comparable transaction under the three methods explicitly stated in the section 482 regulation, the court applied a profit-split approach. The profit split resulted in the allocation of 45% of the intangible income to Lilly as a marketing profit and 55% of the intangible income to Lilly's possession subsidiary as a manufacturing profit. The Tax Court simply stated that with regard to the 45-55 profit split, the court had used its best judgment and that the taxpayer's failure to support the transfer prices under the arm's length standard was to its own detriment.

On appeal, the Seventh Circuit affirmed the Tax Court's profit split, but refused to enforce the court's allocation of some of Eli Lilly's general research and development expenses to its subsidiary. The appeals court thus affirmed the Tax Court's decision to reject Lilly's allocation method, but reversed in part with regard to how the Tax Court had applied its alternative method. Since the Tax Court did not specify the amount of this particular allocation, the appeals court remanded the case. Regardless of the 45-55 profit split, Lilly still managed to reduce its tax liability significantly by transferring the manufacturing intangibles to its Puerto Rican subsidiary.

The Service perceived several cases as pro-taxpayer. In G.O. Searle & Co. v. Commissioner the taxpayer transferred the patents or licenses related to five out of the company's seven major product lines to its subsidiary, Searle & Co. (hereinafter SCO), which was operating as a possession corporation in Puerto Rico. Searle subsequently marketed the products in the United States acting as an agent of its subsidiary, SCO. The intangible accounted for close to 80% of Searle's profits. The Service argued for a section 482 reallocation of the profits from the intangibles. The Tax Court found previous licenses held by Searle to be noncomparable and refused to use them as a safe harbor when resolving the case. The Tax Court mandated a profit

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70. 84 T.C. at 1152-53. A profit-split approach treats the members of a controlled group as a single economic entity, allocating its total net profit among the separate members based on their respective economic contributions. See I.R.C. § 936(h)(5)(C)(ii)(II) (1986).
71. 84 T.C. at 1167.
72. Id.
74. Id. at 85,471.
75. Id.
76. See Driscoll, supra note 60.
77. 88 T.C. 252 (1987).
78. Id. at 271-72. Searle, through SCO's exploitation of Searle's manufacturing intangibles, achieved a massive income shift outside of the U.S. tax base while concurrently experiencing net losses from multimillion dollar deductions for research and development costs. Congress created the deductions as an intended tool for increasing research and development.
79. Id. at 370.
80. Id. at 256.
81. Id. at 374. Previously Searle had licensed two of the five controverted intangibles from a European pharmaceutical firm through licensing agreements requiring 8-10% of net sales as royalty payments. Id. The Tax Court found that the licensing agreements failed to constitute unrelated party transactions under the arm's length standard because the parties consummated the agreements before the Food and Drug Administration ever approved the
split\textsuperscript{82} of 25\%, which the Treasury felt allocated too small a percentage of profits from the possession corporation, SCO, to the parent corporation, G.D. Searle & Company.\textsuperscript{83}

Like Searle, the court in \textit{Hospital Corporation of America v. Commissioner}\textsuperscript{84} applied a profit-split approach in a situation classified as not technically appropriate for the use of a fourth method.\textsuperscript{85} The court allocated 75\% of the profit to Hospital Corporation of America for the transfer of its extremely profitable and noncomparable intangibles.\textsuperscript{86} The Treasury once again felt that the reallocation resulted in too little profit allocated to the parent corporation.\textsuperscript{87}

The three cases described above dealt with the situation in which no adequate comparables existed. In \textit{United States Steel Corp. v. Commissioner}\textsuperscript{88} the parent company, U.S. Steel, accounted for approximately 75\% of the business transacted by its subsidiary, Navios.\textsuperscript{89} Navios and U.S. Steel's shipping contracts covered substantially longer periods of time than Navios's other shipping contracts.\textsuperscript{90} Navios, however, charged U.S. Steel the same rates that it charged unrelated parties.\textsuperscript{91} The Service contended that the rate Navios charged for shipping ore from Venezuela to the United States exceeded an arm's length rate. The Service introduced figures indicating that U.S. Steel could have shipped the same amount of ore for considerably less money.\textsuperscript{92} U.S. Steel argued that a perfect comparable existed because Navios charged U.S. Steel and unrelated parties the same shipping rates, and the comparable adequately represented an arm's length price.\textsuperscript{93}

Hearing the case on appeal, the Second Circuit found the unrelated party transactions constituted appropriate comparables.\textsuperscript{94} The court held that when an appropriate comparable existed to justify the price charged, an allo-

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\textsuperscript{82} Cf. \textit{Eli Lilly & Co. v. Commissioner}, 84 T.C. 996 (1985). The Tax Court's profit split technically falls outside the gambit of the "fourth method" profit split utilized in \textit{Lilly} since SCO did not sell the products to Searle and therefore no intercompany sales income existed for the court to reallocate under Treas. Reg. § 1.482-2(e)(1)(iii).

\textsuperscript{83} \textit{Searle}, 88 T.C. at 376. The original allocation proposed by the Service allocated more than 92\% of SCO's gross income to G.D. Searle & Co. \textit{Id.}

\textsuperscript{84} \textit{81 T.C.} 520 (1981).


\textsuperscript{86} \textit{81 T.C.} at 601. Hospital Corporation of America describes its "system" in an annual report: "The combination of medical-financial-administrative orientation and skills at all levels of the management structure provides the ideal combination for the effective management of hospitals. It is unique within the health care industry and is one of the company's most important competitive advantages." \textit{Id.} at 600.

\textsuperscript{87} \textit{Id.} at 602. The IRS argued for a 100\% allocation of the profits to Hospital Corporation of America. \textit{Id.}

\textsuperscript{88} \textit{617 F.2d} 942 (2d Cir. 1980), rev'g 36 T.C.M. (CCH) 586 (1977).

\textsuperscript{89} \textit{United States Steel}, 36 T.C.M. at 598.

\textsuperscript{90} \textit{Id.} at 595.

\textsuperscript{91} \textit{Id.} at 594.

\textsuperscript{92} \textit{Id.} at 605.

\textsuperscript{93} \textit{Id.} at 602.

\textsuperscript{94} \textit{United States Steel Corp. v. Commissioner}, 617 F.2d 942, 942-43 (1980).
cation under section 482 would not apply even if the upholding of the com-
parable potentially results in the shifting of tax liability between related
parties. In holding that the shipping services were adequately similar, the
court found the term "comparable" not synonymous with the term
"identical."

In an earlier case in the transfer pricing area, *R. T. French & Co. v. Com-
missioner*, the Tax Court addressed the controversial issue of using hind-
sight to evaluate intercompany royalty agreements. *R. T. French* involved a
twenty-year license between a British corporation and its U.S. affiliate R.T.
French. The license allowed the U.S. company to manufacture instant
mashed potatoes following a patented process. The Service alleged that the
U.S. licensee received very little benefit for the royalty payments in the final
two years of the twenty-year license. By 1963 the patented process for
making instant mashed potatoes was no longer unique and the food industry
commonly understood the process. The Tax Court ruled in favor of the
taxpayer, upholding the royalty payments. The court stated that if a li-
censing agreement contained reasonable payments in accordance with arm's
length principles at its creation, then the IRS could not subsequently reallo-
cate under section 482 purely on hindsight. Regardless of the judiciary's
view on the use of hindsight, the IRS supported its hindsight approach in a
1973 Technical Advice Memorandum. The memorandum advocated
yearly review of long-term agreements to determine whether unrelated par-
ties in the same circumstances would modify the agreement.

The aforementioned cases further amplified the Treasury Department's
dissatisfaction with the current transfer pricing structure. The Treasury De-
partment felt that United States companies were engaged in researching and
developing patents, copyrights, and know-how in the United States while at

95. *Id.* at 951.
96. *Id.*
97. 60 T.C. 836 (1973).
98. *Id.* at 850.
99. *Id.* at 854.
100. *Id.*
101. *Id.* at 836.
102. *Id.* at 854; see also Gulf Oil Corp. v. Commissioner, 87 T.C. 548, 567 (1986) (in the
    absence of contract provisions, court held that market fluctuations are risk factor in long run
    as well as short term and that reasonableness of rate viewed with clarity of hindsight held
genraly irrelevant).
103. I.R.S. Technical Advice Memorandum 8,002,001 provides:
    We believe that a reevaluation should be made for each subsequent year to de-
terminie if unrelated parties would have continued under the arrangement. . . .
    [In determining whether unrelated parties would have continued under Agree-
ment J [the agreement that the letter ruling concerns], the more specific inquiry
    is whether unrelated parties would have continued under that Agreement where
    each of the parties possessed the right to terminate the Agreement on one-year's
    notice.
Tech. Adv. Mem. 8,002,001 (May 20, 1979). The case and the technical advice memorandum
suggest conflicting ideologies between the judiciary and the administrative branches of the
government. By issuing Technical Advice Memorandum 8,002,001, the Service expressed its
refusal to yield to the Tax Court's attempt to usurp the agency's § 482 power.
104. *Id.*
the same time reaping the benefits of their expenditures on their present U.S. tax returns. The Treasury felt that the U.S. companies subsequently transferred or sold the same intangibles to related foreign affiliates, preferably located in a tax haven, for a much lower price than to unrelated parties in the same situation. The Treasury perceived further violations of the arm's length standard when companies used inside information to selectively transfer incomplete or untested intangibles, a system commonly referred to as "cherry picking."

D. Defects in the Arm's Length Standard

The number of international business transactions in the last few decades has increased dramatically. Traditionally, international business transactions have involved the imports and exports of end products. Companies eventually realized, however, that more active involvement in international markets translates into higher profits. Companies transacting business internationally ultimately developed into multinational conglomerates. As a result, a decrease in the amount of unrelated transactions accompanied the growth of many large corporations. Consequently, taxing authorities anticipated a storm of unanswered issues on the horizon.

Congress began to express concern that the pre-1986 regulatory scheme dealing with intercompany transfer pricing issues had failed to accomplish the goal of establishing uniform arm's length prices. The problems with the scheme consist of lack of comparables, lack of one price, differing facts and circumstances, and uncertainty of application. The lack of comparables necessary to determine an arm's length price constitutes a key problem in related party transactions. At the far end of the spectrum, industries such as the vertically integrated petroleum industry operate in an environment virtually without unrelated party transactions. More commonly, the problem of inadequate comparables arises in situations where companies keep their more lucrative know-how and intangibles to themselves. Companies in this situation prefer to exploit the intangible or know-how through existing or future facilities and personnel all within a commonly controlled group.

The statute's view of how corporations operate amplifies the lack of comp-

105. Looman, supra note 14, at 2. The Treasury also perceived abuses of cost-sharing agreements in which the parent corporation received no credit for prior research.
106. Id.
107. Id.
110. See Schindler, supra note 57, at 379.
111. Id.
113. Id. at 423-26.
114. Id. at 423-24. The report noted that transactions between unrelated parties also presented the problem of inconsistent results derived while attempting to apply the arm's length standard in the absence of comparables. Id.
115. See Schindler, supra note 57, at 379-80.
parables problem for pricing considerations. Section 482 treats all corporations in a controlled group of companies as unrelated parties. In reality relationships differ between related and unrelated parties. Multinational corporations conduct operations on a company-wide level acting as one related company. The parent corporation treats affiliates and subsidiaries as related parties. Attempting to treat these subsidiaries and affiliates as other than related parties creates a legal fiction. The commonly controlled group operates more efficiently than unrelated corporations because certain functions benefit all of the related companies, eliminating the need for each company to perform them separately. Examples of such functions include product development, market planning, and administrative functions. Furthermore, related party transactions involve much less risk than unrelated party transactions. The benefits of a particular transaction contribute to the equity interest of the related parties as a whole, with little regard to the transfer price selected.

The lack of a single price and the absence of similar facts and circumstances also complicate the task of attempting to apply the arm's length standard. An arm's length analysis commonly allows for a range of prices, including many single prices. Current business practices exemplify this problem: The price that an unrelated company pays for a product is contingent upon factors such as general market conditions, availability of the product, past dealings between buyer and seller, and the seller's incentives. The failure to consider varying facts and circumstances is inherent in the problem of attempting to determine a single price.

Corporations also often make current business decisions based on long-term goals and objectives. A current pricing decision of a company will not necessarily represent a true arm's length price. An arm's length comparable transaction based upon a corporation's attempting to break into a new market fails to reflect the arm's length price applicable to related parties attempting to exit from a certain market. The unrelated parties' arm's length price appears adequate on its face, but the facts and circumstances differ in an economic sense from those of the related parties. The same

118. See Schindler, supra note 57, at 380. Related parties benefit through the use of structural interaction such as horizontal and vertical integration of resources, mechanisms not available to unrelated parties. Id.
119. Id.
120. Id.
121. Id.
122. Id.
123. Id.
125. Id. at 634.
126. See id.
127. Id.
129. Id.
130. Id.
problems occur on a micro level. The unrelated arm's length price that exceeds the related party's price may ignore the fact that the related buyer experiences different credit terms, warranties, services, and support than the unrelated buyer.\textsuperscript{131}

The final problem with the arm's length standard centers on uncertainty involved in determining an arm's length price.\textsuperscript{132} The regulations go into great detail in describing the methodology for determining an arm's length price.\textsuperscript{133} In the area of tangible property, the regulations provide for a subjective judgment by the taxpayer in reconciling potential comparables with the actual transaction.\textsuperscript{134} Factors to be considered include quantity, terms, and time of the sale, plus pretense of intangibles and level of the market.\textsuperscript{135} Evaluation of the factors relevant to the transfer and use of intangibles also requires subjective determinations of whether and to what extent they affect the price of the comparable and whether a comparable transaction exists at all.\textsuperscript{136}

\section*{II. THE EVOLUTION OF THE SUPER ROYALTY PROVISION}

\textit{A. Transferring Intangibles: A Statutory Quagmire}

Congress eventually acknowledged, in light of the aforementioned circumstances and the growth in the amount of international business, that the existing regulatory scheme operated ineffectively. Consequently, the 1980s marked the beginning of a series of congressional enactments designed to deal with the potential tax avoidance associated with prohibited transfers and sales of intangible property among commonly controlled companies. In 1982, 1984, and 1986, Congress respectively enacted Code sections 936(h), 367(d), and amended Code section 482.\textsuperscript{137}

The conduct of companies like Eli Lilly forced Congress to reconsider the existing tax statutes concerning the outbound transfer and sale of intangibles originating in the United States.\textsuperscript{138} Prior to 1982, section 936 granted do-

\begin{itemize}
  \item \textsuperscript{131} \textit{Id.}
  \item \textsuperscript{132} See, e.g., E.I. Du Pont De Nemours & Co. v. United States, 608 F.2d 445 (Ct. Cl. 1979) (rejecting taxpayer's comparison to 21 distributors in favor of Commissioner's "reasonable" reallocation); PPG Indus., Inc. v. Commissioner, 55 T.C. 928 (1970) (finding taxpayer's statistics-based allocation system arbitrary and unreasonable); Hamburger York Road, Inc. v. Commissioner, 41 T.C. 821 (1964) (holding two corporations subject to § 482 reallocation based on lack of pressing business need for separate entities).
  \item \textsuperscript{133} See Treas. Reg. § 1.482-1(d) (1968).
  \item \textsuperscript{134} See § 1.482-2(e)(1).
  \item \textsuperscript{135} § 1.482-2(e)(1) to -2(e)(4).
  \item \textsuperscript{136} § 1.482-2(d)(1) to -2(d)(4).
  \item \textsuperscript{138} Although the Tax Court did not decide \textit{Eli Lilly} until 1985, the 1982 Senate report on TEFRA makes reference to the intangible income tax exploitations of "a U.S. pharmaceutical company." S. REP. NO. 494, 97th Cong., 2d Sess. 158 (1982).
\end{itemize}
DOMESTIC CORPORATIONS AN OPTIONAL FEDERAL INCOME TAX CREDIT. The corporations earned the credit primarily by actively conducting business in a possession of the United States. Congress, however, believed that some companies had abused the tax incentives. With the passage of the Tax Equity and Fiscal Responsibility Act (TEFRA), Congress added subsection (h) to section 936. Section 936 imposes special income allocation provisions on corporations that take advantage of the tax credit. The allocations apply to revenue generated from intangibles developed in the United States and then transferred to possession corporations.

Congress next tackled a different problem by enacting section 367(d). The problem arose when U.S. companies developed intangibles in the United States and subsequently used the same intangibles for their foreign manufacturing affiliates. The evil sought to be prevented occurred when a transferor deducted large amounts for research and development and then transferred the intangible at the point of profitability, thereby either deferring or eliminating U.S. taxes on the profits attributable to the intangible.

Section 367(d) provides for an income-shifting rule similar in theory to the one in section 936(h). The rule generally provides for the shifting of income attributable to intangibles to a transferor if the transaction tradition-
ally would qualify for nonrecognition of gain treatment.\textsuperscript{149} The amount of income, if any, depends upon the productivity, use, or disposition of the intangibles.\textsuperscript{150}

After the enactment of sections 936(h) and 367(d), Congress’s control on U.S. corporations’ income shifting tactics remained incomplete. United States companies could still avoid the implications of sections 936(h) and 367(d) by licensing or selling intangibles to a commonly controlled foreign affiliate, instead of implementing a section 367 tax-free transfer.\textsuperscript{151} Congress’s strategy was to amend section 482 with the TRA of 1986.\textsuperscript{152}

The legislative history of the 1986 Act covering section 482 lays out Congress’s reasons for the amendment.\textsuperscript{153} Congress was concerned that the provisions of section 482 inadequately allocated income attributable to intangibles back to the United States parent corporation in certain situations.\textsuperscript{154} Congress recognized a key problem in the case of a U.S. company transferring intangibles to its related corporation in a low tax jurisdiction, especially when the transfer involved high value intangibles. Because of the tax savings available, Congress felt a strong incentive existed for taxpayers to enter into this type of transaction.\textsuperscript{155}

Perhaps the most difficult problem Congress faced concerned the nature of multinational corporations. The relationship between related and unrelated parties differs fundamentally.\textsuperscript{156} Multinational companies conduct business operations as a single economic unit.\textsuperscript{157} Multinational companies do not treat their foreign affiliates in the same manner they treat unrelated

\textsuperscript{149} See § 367(a), (b), (d).

Transfers of intangible assets in transactions that would otherwise qualify for nonrecognition of gain are treated as transfers for payments contingent on productivity, use, or disposition of the property. The transferor is treated as receiving payments over the useful life of the intangible property on an annual basis. Amounts included in gross income by reason of the special rule are treated as ordinary income from sources within the United States.

\textit{Id.}

\textsuperscript{151} See Driscoll, supra note 64, at 180.
\textsuperscript{152} TRA, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986).
\textsuperscript{154} The House report specifically addresses the problems that accompany the transfer of intangibles between commonly controlled corporations:

There is a strong incentive for taxpayers to transfer intangibles to related foreign corporations or possessions corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers can result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group.

The committee is concerned that the provisions of sections 482, 367(d), and 936 that allocate income to a U.S. transferor of intangibles may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations.

\textit{Id.} at 423.

\textsuperscript{155} \textit{Id.}
\textsuperscript{156} \textit{Id.} at 424.
\textsuperscript{157} \textit{Id.}
parties. Multinational companies also incur different levels of risk when transferring high potential intangibles among affiliates than when transferring the same intangibles to an unrelated party. The multinational's equity interest enables the whole economic entity to reap the benefits of the intangibles, irrespective of the transfer price paid for the intangibles. Unlike corporations bound by the terms of contractual agreements, the multinational companies can easily adjust the transfer prices annually when appropriate. Therefore, in consideration of all the aforementioned reasons, Congress enacted the controversial one-sentence amendment to section 482 providing that any income with respect to the transfer or sale of intangibles shall be commensurate with the income attributable to the intangible. The TRA of 1986 also provides for the Code to extend the same "commensurate with income" standard to section 367(d) intangible property transfers to foreign affiliates and to section 936(h) transfer pricing agreements applicable to possessions corporations and their United States affiliates.

B. The Commensurate with Income Standard

The one-sentence amendment to section 482, the super royalty provision, advocates a commensurate with income standard when dealing with sections 367(d), 936(h), and 482. On its face the amendment fails to provide any guidance as to the meaning of the commensurate with income standard. The Random House Dictionary of the English Language supplies four possibilities under the word "commensurate." The second choice gives the definition of corresponding in amount, magnitude, or degree, and provides an

158. Id.
159. Id.
160. Id.
161. Id.
162. TRA, Pub. L. No. 99-514, § 1231(e)(1), 100 Stat. 2085, 2562-63 (1986). Section 1231(e)(1) states: "In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." Id. Code section 936(h)(3)(B) states:

The term "intangible property" means any—
(i) patent, invention, formula, process, design, pattern, or know-how;
(ii) copyright, literary, musical, or artistic composition;
(iii) trademark, trade name, or brand name;
(iv) franchise, license, or contract;
(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
(vi) any similar item,
which has substantial value independent of the services of any individual.
I.R.C. § 936(h)(3)(B) (1986). Compare this section with Treas. Reg. § 1.482-2(d)(3), supra note 53 (providing an almost identical list of intangibles, with the exception of "know-how").
164. See Looman, supra note 14, at 1 (defining the super royalty concept); see also Levey & Ruchelman, supra note 124, at 611 (explaining super royalty concept in the context of I.R.C. §§ 367, 936).
165. The Random House Dictionary of the English Language defines "commensurate" as: (1) having the same measure; of equal extent or duration; (2) corresponding in amount, magni-
example of a person's paycheck being commensurate with the amount of
time worked.166 From Random House's definition, the application of the
commensurate standard may appear reasonably clear. Fortunately, the legis-
slative history provides some additional insight as to the meaning and appli-
cation of the commensurate with income standard.167

The legislative history specifically points out that the standard applies to
outright transfers as well as licenses and other arrangements for the use of
intangibles.168 This stipulation eliminates the previous problem of corpora-
tions entering into licensing or royalty agreements rather than outright
transfers in order to avoid taxes.169 The committee expressly stated that
neither industry norms nor unrelated party transactions provide a safe har-
bor minimum payment.170

To determine if payments are commensurate with the income attributable
to the intangible requires more than a strict application of a particular
method of allocating income.171 The committee intended for the profit or
income stream generated or associated with the intangible property to serve
as the primary factor in determining an appropriate pricing method.172 In
addition, all of the facts and circumstances surrounding a transaction are
relevant.173 The facts and circumstances include the economic risks each
party bears in relation to the particular transaction.174

The legislative history indicates that an examination into the compensa-
tion for an intangible should not be limited in scope to the facts and circum-
cstances existing at the time of the transfer.175 The commensurate with
income standard allows future consideration of the actual profits realized
pursuant to the transfer of intangibles.176 The future consideration of facts
permits adjustments in payments for the intangible in order to account prop-
tude, or degree . . . ; (3) proportionate; adequate; (4) having a common measure; commensura-
166. Id.
Finance Committee and the House of Representatives issued reports on the TRA of 1986,
Report No. 426 (prepared by the House Ways and Means Committee) appears to analyze the
issues pertaining to the super royalty provision with the most thoroughness and insight.
169. Id.
170. Id.
171. Id. at 426. Congress specifically refused to mandate the application of the contract
manufacturer or the cost-plus methods. Id.
172. Id.
173. Id.
174. Id. The committee emphasized:
All the facts and circumstances are to be considered in determining what pricing
methods are appropriate in cases involving intangible property, including the
extent to which the transferee bears real risks with respect to its ability to make
a profit from the intangible or, instead, sells products produced with the intangi-
ble largely to related parties (which may involve little sales risk or activity) and
has a market essentially dependent on, or assured by, such related parties' mar-
ketin efforts.

Id.
175. Id. at 425.
176. Id. "The committee intends that consideration also be given the actual profit experi-
ence realized as a consequence of the transfer." Id.
erly for changes in the amount of income attributable to the intangible. The legislative history reflects Congress's intent to adjust payments only in situations involving major changes in income attributable to the intangible.\textsuperscript{177} Consequently, congressional intent reflects the understanding that annual adjustments are not necessary, absent a major change.\textsuperscript{178}

The explanation also states that the standard applies to both sections 367(d) and 936.\textsuperscript{179} Likewise, the section addresses cost-sharing agreements.\textsuperscript{180} The payments under a cost-sharing agreement\textsuperscript{181} must equal or exceed royalty payments the possessions corporation would pay an affiliated corporation under sections 367 or 482.\textsuperscript{182}

C. Ripples in International Treaty Waters

The 1986 amendment to section 482 mandating the commensurate with income standard creates much uncertainty in the international arena.\textsuperscript{183} Taxing authorities throughout the world focus concern on the same types of problems that section 482 addresses, namely the shifting of profits between related companies that ends up distorting taxpayers' taxable income in the different tax jurisdictions where they operate. Traditionally, the taxing authorities adjust the profits of related companies through the use of allocations based on an arm's length standard.\textsuperscript{184}

In 1977 the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD) adopted the Revised Model Double Taxation Convention on Income and Capital (Model Convention).\textsuperscript{185} The Model Convention generated the groundwork for resolving potential taxing conflicts among member countries. In 1979 the OECD prepared and adopted a report titled "Transfer Pricing and Multinational Enterprises" (1979 Report)\textsuperscript{186} based on the 1977 Model Convention. The 1979 Report first deals with the problems associated with related companies' practices of distorting taxable income through the abusive use of intercompany pricing methods.\textsuperscript{187} The solution purportedly lies in the application of the arm's length standard.\textsuperscript{188} Article 9(1) of the Model Convention prescribes that when a trans-

\textsuperscript{177} \textit{Id.} at 425-26.
\textsuperscript{178} \textit{Id.} at 426.
\textsuperscript{179} \textit{Id.} at 425-26.
\textsuperscript{180} \textit{Id.} at 426.
\textsuperscript{181} Previously, bona fide cost-sharing agreements enjoyed the benefit of nonallocation under § 482 as long as both parties shouldered an arm's length share of the costs and risks related to the development of the product. \textit{See} Treas. Reg. § 1.482-2(d)(4) (1969).
\textsuperscript{183} \textit{See} Granwell & Hirsh, \textit{The Super Royalty: A New International Tax Concept}, 33 \textit{TAX NOTES} 1037 (1986).
\textsuperscript{184} \textit{Id.} at 1047-49.
\textsuperscript{187} \textit{See id.} ch. 1, at 13.
\textsuperscript{188} \textit{Id.} at 23.
action between related parties fails to comply with the arm's length standard, a reallocation of profits will be made in order to achieve an arm's length result.\textsuperscript{189}

The 1979 Report also addresses the problem of double taxation. Double taxation occurs when an overlap in taxable income exists after separate taxing authorities independently determine the amount of income includable in their respective tax basis.\textsuperscript{190} Specifically, double taxation occurs when a country arrives at a transfer price, after adjusting inter-company transactions, that includes income previously taxed by another taxing authority.\textsuperscript{191} The solution to the problem of double taxation lies in articles 9(2) and 25 of the Model Convention. Countries following article 9(2) provide for the subsequent taxing authority to decrease the amount of tax owed in a way that takes into account the tax already imposed on the overlapping profits.\textsuperscript{192} Article 9(2) appears to discriminate against the later taxing authority. Article 25, however, includes procedures for achieving mutual agreement between the "competent authorities" of the taxing jurisdictions in conflict.\textsuperscript{193} The competent authorities must negotiate the amounts of the corresponding adjustments in order to alleviate the burden of double taxation on an enterprise.\textsuperscript{194}

United States treaty obligations represent another limit on the broad powers of the Internal Revenue Service.\textsuperscript{195} The 1979 Report describing United States tax treaties provides for application of an arm's length standard.\textsuperscript{196} The question now arises as to whether the commensurate with income standard, in light of the White Paper, complies with United States treaty obligations.

\textbf{D. The Section 482 White Paper}

With the amendment of section 482, members of the private sector, both domestically and abroad, have begun speculating over the Code section's reach. One scenario depicts an omnipotent taxing authority with a blank ticket to allocate income and deductions as necessary in order for royalty payments to be "commensurate" with the income attributable to the intangible. A less drastic scenario paints the amendment to section 482 as merely codifying the use of the section 482 regulation's unspecified fourth method, resulting in a change of small magnitude.

The legislative history of the super royalty provision of the Tax Reform Act of 1986 strongly urged the IRS to study intercompany pricing rules and consider possible changes to the regulations providing guidelines for the ap-

\textsuperscript{189} Id.
\textsuperscript{190} Id. at 8-9.
\textsuperscript{192} Id.
\textsuperscript{193} Id.
\textsuperscript{194} Id.
\textsuperscript{195} See Schindler, \textit{supra} note 57, at 380.
\textsuperscript{196} OECD 1979 REPORT, \textit{supra} note 186, at 10.
The completed study, the Section 482 White Paper, asserts that the appropriate standard for international transactions is the arm's length standard. The White Paper then argues that the commensurate with income standard complies with the arm's length standard, and consequently, follows the spirit of international tax treaties. The White Paper also goes into great depth concerning the application of the commensurate with income standard and touches on the subject of cost-sharing.

A thorough examination of section 482 and the entire Internal Revenue Code fails to produce any definition for "commensurate" or "commensurate with income." Likewise, the legislative history also fails to define the entire scope of the commensurate with income standard. The legislative history mandates the use of the standard for inbound and outbound transfers of all related party transfers of intangibles. The Treasury Department in the White Paper widens the scope of the commensurate with income standard to apply regardless of qualitative or quantitative restrictions. The White Paper rejects the proposition that the commensurate with income standard should apply only to high profit potential intangibles.

As previously intimated, the commensurate with income standard applies to both normal and high profit potential intangibles. The White Paper mentions that normal profit intangibles cause few problems with the commensurate with income standard. Normal profit intangibles commonly lend themselves to comparison with unrelated party intangibles. The presence of unrelated comparables assures the existence of an arm's length price. Therefore, the results of the commensurate with income standard coincide with pre-1986 results as long as appropriate comparables exist.

The high profit potential intangibles posed a different challenge to the drafters of the White Paper. The absence of comparables led to an uproar, eventually leading to the issuance of the White Paper. Economically, in order to reflect the often minor contributions of a transferee, the transferor must pay a "super royalty" rate. The White Paper gives credence to the legislative history that requires the IRS to place primary weight on the income attributable to a transferred intangible in the application of the commensurate with income standard.

The White Paper explains the Treasury Department's and Service's views on the interpretation of the commensurate with income standard. The

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199. Id. at 56.
200. See id. chs. 6, 8, at 45, 63.
201. Id., ch. 6, secs. C, D, at 50, 52.
202. Id. at 52.
203. See id., ch. 6, secs. C, D, at 50, 52.
204. Id.
205. Id.
206. Id. at 51.
207. See id., ch. 6, pt. A, at 45 (discussing legislative history).
208. Id. at 1-2.
White Paper provides an economic perspective—functional analysis—in determining the appropriate transfer price in difficult situations, particularly in the case of super royalties.\textsuperscript{209} Beginning with the amount of income derived from the sale of a particular product, the functional analysis method splits the amount of income into two distinct categories, tangible income and intangible income.\textsuperscript{210} The identification of the intangible income represents the first step in the functional analysis method of allocating income.\textsuperscript{211} The next step of the functional analysis involves the proper allocation of the intangible income between the related companies. In order to allocate the intangible income, functional analysis requires close economic scrutiny of all factors necessary in bringing the product to and through the various stages of production. The economic analysis predicts the amount of return that the related companies' manufacturing operations should produce and hence acts as the main tool for allocating intangible income between the related companies in a way that properly reflects their respective efforts.\textsuperscript{212}

The economic analysis of the factors of production requires the assignment of various rates of return to the factors.\textsuperscript{213} Examples include the expected economic rate of return for manufacturing plants and labor forces.\textsuperscript{214} In order to complete the economic analysis, functional analysis places much emphasis on examining the costs and risks borne by each party.\textsuperscript{215} The results of the functional analysis should necessarily lead to the proper allocation of the intangible income. Upon the completion of the functional analysis, the IRS must decide if the amount the manufacturer paid for the intangible, either outright or in the form of a royalty, properly takes into account the allocation of intangible income.

The White Paper depicts the commensurate with income standard and the arm's length principle as consistent approaches to dealing with transfer pricing problems. The White Paper posits that the application of functional analysis on the actual profit experiences from an intangible exemplifies the behavior of unrelated parties in the same or similar facts and circumstances. The commensurate with income standard applies a functional analysis approach to an intangible's income. Thus, the commensurate with income standard is consistent with the arm's length principle.\textsuperscript{216}

The same logic applies to the use of periodic adjustments under the commensurate with income standard. The commensurate with income standard requires the use of periodic adjustments to reflect appropriately the actual profit experienced under a license for intangibles.\textsuperscript{217} Potentially high-profit intangibles under long-term, fixed royalty rate licenses (originally negotiated

\textsuperscript{209} Id. at 47.
\textsuperscript{210} Id.
\textsuperscript{211} See procedure set out infra in section III.B. (illustrating the steps involved in functional analysis as applied to a hypothetical bicycle manufacturer).
\textsuperscript{212} White Paper, supra note 16, at 84.
\textsuperscript{213} Id.
\textsuperscript{214} See id. at 86 (using the term "measurable assets").
\textsuperscript{215} Id. at 54.
\textsuperscript{216} Id. at 84.
\textsuperscript{217} Id. at 63.
at arm's length) exemplify a situation in which the White Paper strongly recommends periodic adjustments. When these intangibles subsequently realize high profits, the absence of periodic adjustments allows taxpayers substantial unplanned tax savings. Following the arm's length approach, avoidance of periodic adjustments and the accompanying increase in tax burden requires a showing that unrelated parties dealing at an arm's length basis would not require any adjustments. Thus, a taxpayer may avoid periodic adjustments and avoid an increase in tax burden. Conversely, if changing circumstances require unrelated parties to renegotiate and adjust royalty payments, the White Paper's application, consistent with the arm's length standard, requires periodic adjustments to the royalty rate. Consequently, periodic adjustments under the commensurate with income standard follow arm's length principles.

The consistency of the commensurate with income standard and arm's length principles arguably helps to control, or at least does not aggravate, the problems of double taxation. While insisting that the arm's length standard in U.S. tax treaties remains intact, the White Paper acknowledges the lack of comparables in the area of potentially high profit intangibles. Because of the arm's length standard's inability to handle the super royalty type of situation, the commensurate with income standard fills this gap in the tax treaties. Through the application of the commensurate with income standard, the United States theoretically should be able to handle the conflicting interpretations of the arm's length standard offered by our treaty partners.

The White Paper describes the application of the commensurate with income standard in great detail. The Paper also makes reference to cost-sharing agreements. In accordance with legislative intent, cost-sharing agreements no longer enjoy protection from section 482. All bona fide cost-sharing agreements must comply with the commensurate with income standard. The White Paper stresses that Congress directed “the Service to make adjustments to intangible returns that reflect the actual profit experience [which] is in part a legislative rejection of R.T. French v. Comm'r.”

The White Paper implies that practical negotiators generally enter long-term royalty rate agreements that include a mechanism allowing for rate adjustments over time. Id. at 66. Id. at 71. Id. at 71. See id. at 54 (noting lack of comparables for high profit potential intangibles); see also id. ch. 7, at 56 (asserting no deviation from arm's length standard concept).


Cost-sharing agreements no longer enjoy protection from section 482. All bona fide cost-sharing agreements must comply with the commensurate with income standard.

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218. Id. The White Paper stresses that Congress directed “the Service to make adjustments to intangible returns that reflect the actual profit experience [which] is in part a legislative rejection of R.T. French v. Comm'r.” Id.

219. See id. The White Paper implies that practical negotiators generally enter long-term royalty rate agreements that include a mechanism allowing for rate adjustments over time. Id. at 71.

220. Id. at 66.

221. Id. at 71.

222. See id. at 54 (noting lack of comparables for high profit potential intangibles); see also id. ch. 7, at 56 (asserting no deviation from arm's length standard concept).


224. See id. at 54; see generally id. at 109-20.


III. **THE BASIC VARIABLE FORMULA: A PROPOSAL FOR COHESION IN THE METAPHYSICAL WORLD OF INTANGIBLES**

**A. Functional Analysis in Theory**

The companies subject to the highest prospects for encountering a section 482 controversy have traditionally enjoyed extremely high royalties, from which the IRS would like its fair share.229 These companies' "super royalties" evidence a recent phenomenon. Congress's legislative effort to deal with super royalties did not appear until the passage of the TRA of 1986.230 One main goal of the post-1986 section 482 pricing structure centers around achieving an arm's length price for transactions between related parties. The White Paper stresses that in arriving at an arm's length price, exactly comparable transactions carry the most weight and are always preferred.231

One side effect of the relatively new phenomenon of super royalties is the lack of exact comparables. The solution appears to be functional analysis, implemented under the commensurate with income standard. Functional analysis is touted in the White Paper as the regulations' appropriate, unspecified "fourth method," but in reality the White Paper reclassifies and expands the previous methods used in determining transfer prices. The White Paper, like the Code, also fails to provide an ironclad definition of the phrase "commensurate with income." Examples of functional analysis applied under the commensurate with income standard appear in abundance in the White Paper,232 but the phrase remains ambiguous and subject to interpretation.

Attempting to apply the White Paper's functional analysis method under the commensurate with income standard subjects the taxpayer to considerable uncertainty. The application of the functional analysis method relies on the economic analysis of factors of production implemented by a manufacturing entity. Functional analysis includes calculating economic rates of return on the various factors of production. The White Paper provides little or no guidance on how to establish uniformity and comparability in the use of these rates that play such an integral role in the government's scheme. In order to calculate an appropriate transfer price, functional analysis should incorporate as many predictable and quantitative elements as possible. At a minimum, the economic rates of return should originate from a uniform source, thereby reducing unknowns and increasing security for the taxpayer.

**B. Functional Analysis Applied**

An example best serves to compare the conceptual aspects of both the traditional arm's length method of transfer pricing and the functional analy-
sis approach. Assume that an American company, Le Tour, engages in the business of developing, manufacturing, and marketing high performance bicycles. The goal of all high performance bicycle designers and manufacturers is to produce a model that weighs very little, and yet functions as well or better than heavier bikes. The lightest high performance bicycles on the market weigh between seventeen and twenty-one pounds. The four-pound difference results in a retail price differential of two to three thousand dollars per bike.

Le Tour recently produced a new bicycle, Le Light, after many years of research and development. Le Light weighs only thirteen pounds, and performs as well if not better than the heavier cycles. Le Tour sets up a manufacturing subsidiary, Le Plant, in foreign county $L$, which has a lower income tax rate that the United States. Le Tour licenses the technical know-how to produce the bikes to Le Plant. The technology represents all of the research and development efforts of Le Tour. The subsidiary agrees to pay Le Tour a royalty of $100 per bike for the use of Le Tour's intangible, the technology. Le Plant then sells the bikes to the parent company for $3,000 each. Le Tour subsequently packages the bikes in custom boxes and markets Le Light through its sources for $5,000 per bike.

The Internal Revenue Service audits the parent corporation, applying the new super royalty provision as interpreted in the White Paper. The Service finds the arm's length standard ineffective in determining an appropriate transfer price. The arm's length standard requires the comparison of Le Plant's transfer price to the price at which unrelated parties would buy and sell bikes comparable to Le Light. No other bicycle manufacturer produces a bike comparable to Le Light, however, since its unique aluminum alloy puts it in a class by itself. The Service, therefore, cannot compare Le Tour's pricing scheme with any other parties, related or unrelated.

The IRS's examiners realize a gap exists in the arm's length standard as a tool for allocating income of related organizations. The White Paper provides the means to seal this gap. The Service initially examines Le Light's various costs of production and determines that $500 of the total income derived from the sale of a single bike represents intangible income. The $500 reflects the efforts of both Le Tour and Le Plant in designing and producing the end product. The question becomes one of how to allocate properly the $500 of intangible income.

Le Plant's factors of production include the plant, equipment, and labor necessary to manufacture the bicycles. The parent company financed most of the cost of setting up the plant, and as a result bears the clear majority of the risk in the operations of Le Plant. The IRS correlates the expected rates of return with the factors of production, taking into account the respective costs and risks of Le Tour and Le Plant. After a careful and detailed analysis, the Service determines that Le Tour must recognize $350 of intangible income per bike, and Le Plant the remaining $150.

In the previous situation, Le Tour's income, with respect to its licensing of technology to Le Plant, fell short of qualifying as commensurate with the
income attributable to this intangible. The increase in the royalty payment, $250, equals the intangible income of Le Tour, $350, less the original royalty payment of $100. The increase in the royalty from Le Plant to Le Tour results in an increased income realization for Le Tour, located in a tax jurisdiction with a higher rate than Le Plant's. Thus the entire entity, consisting of the parent corporation and its subsidiary, now has fewer after-tax dollars than prior to the government's section 482 reallocation.

C. Treaty Considerations

The treaty obligations of the United States have historically put an effective restraint on the power of section 482.233 The universally accepted standard applied in transfer pricing is the arm's length price.234 When the United States' treaty partners feel a taxing policy conflicts with the arm's length principle, they respond in the same manner as they would to any perceived treaty violation. For foreign taxing jurisdictions to accept functional analysis while remaining in compliance with treaty provisions that prohibit double taxation will effect a decrease in the foreign country's tax revenue. The loss of tax revenue resulting from the United States' imposition of its super royalty provision will undoubtedly be a source of major international controversy.

To alleviate the problem of foreign taxing jurisdictions rejecting functional analysis and consequently entering into a stalemate of tax negotiations, the White Paper stresses that the commensurate with income standard clearly falls within the arm's length standard.235 Arguably the application of the commensurate with income standard through use of the functional analysis method produces results reasonably consistent with those arrived at by unrelated parties dealing at arm's length. Nevertheless, the complexity and uncertainty over what to include in the White Paper's interpretive formulation of the commensurate with income standard cast a dark shadow over the White Paper's consistency argument. Treaty partners armed with U.S. treaties that clearly embody the traditional arm's length standard with regard to prices might easily reject the White Paper's consistency argument. Functional analysis creates a royalty rate for the use of, or a transfer price for the outright sale of, intangibles by determining an amount of intangible income. Nevertheless, the actual use of factors of production, economic rates of return, and the costs and risks of the various parties to arrive at intangible income abandons the traditional application of the arm's length standard.

D. The Basic Variable Formula

The success of the commensurate with income standard depends upon its

233. See Looman, supra note 14, at 6. Looman makes the observation that "[a]rticle 9 of the OECD and U.S. model treaties obligate treaty partners to agree on transfer pricing adjustments so that adjustments to only one member of a multinational group will not result in double taxation." Id.

234. See OECD Report, supra note 186, at 10; see also Treas. Reg. § 1.482-2(d)(2)(i).

full-fledged application domestically, as well as its acceptance by the United States' treaty partners. The obstacle in the path of the standard's success lies in its practical application, not in the standard's concept. A Basic Variables Formula (BVF) approach to functional analysis provides a means of practical application that is in accordance with the commensurate with income standard. The BVF is determined by:

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\text{(expected rate of return)} \times \text{(factors of production)} + \text{(costs borne by both parties)} + \text{(risks borne by both parties)} = \text{intangible income to be allocated to each party}
\]

Comparing each party's intangible income to the royalty payment yields the amount of reallocation.

The elements "expected rates of return" and "factors of production" should be carefully spelled out. Uniform expected rates of return provide some security for the party attempting to calculate the proper allocation or justify the end result. A specific list of the factors of production also decreases the amount of uncertainty for taxpayers and foreign taxing authorities. Use of the BVF will allow taxpayers to comply more easily with the statute. More importantly, foreign taxing authorities may perceive the BVF functional analysis as a useful tool in filling the gaps created by the arm's length standard. The simplicity of application plays an important role in promoting the idea of functional analysis internationally.

In the past, corporations acting in good faith have futilely expended substantial resources in an effort to comply with the government's ambiguous and complex taxing scheme. Under the White Paper's interpretation of functional analysis, arriving at a transfer price that the Service will find palatable continues to be a venture through a maze. Even a preliminarily accurate calculation runs the risk of subsequent periodic adjustments. Rather than frustrating the private sector to the point of noncompliance, the Service should implement a BVF approach to the section 482 regulations and recognize the indirect tax benefits of a less encumbered business environment.

IV. CONCLUSION

Operating in a tax system that generally perceives corporations as separate entities, American corporations have long recognized the advantage of shifting the revenues and expenses of various companies under common ownership control to achieve maximum tax benefits. The dynamics of group operations provide many opportunities for related entities to distort income. Congress, however, has not been oblivious to the problem since it addressed the issue in laws dating back to 1917.

Congress's early attempts to control related companies' tax avoidance focused on grouping companies' income tax reports into one consolidated return. When the consolidated return approach proved ineffective, Congress took far more drastic measures by enacting Code section 45, the predecessor to section 482. Section 482 gave the Internal Revenue Service the power to allocate income and deductions of related corporations seemingly at will. In
the 1960s the Service provided limited protection from what some felt were arbitrary intrusions by issuing regulations that emphasized an arm’s length standard in intercorporate transactions.

Inexorably, the increasing complexity of business transactions accompanied the passage of time. Companies began to transfer both tangible and intangible goods between related affiliates in order to maximize operations. Transfer pricing ultimately outgrew the regulatory scheme placed on it by Congress and the IRS. The government’s 1968 regulations proved but a temporary stay to the problems, especially in the area of intangibles. In response to its eroding statutory infrastructure, Congress, in the Tax Reform Act of 1986, amended Code section 482 by adding the super royalty provision with its commensurate with income standard.

The undefined commensurate with income standard caused considerable speculation in the tax community, domestically and internationally. In a purported effort to explain the application of the super royalty provision and reconcile it with the terms of existing tax treaties, the Treasury Department and the IRS issued the Section 482 White Paper, a 129-page study of intercompany pricing. The White Paper sets forth the government’s official position on the Code’s income allocation provisions as applied under the commensurate with income standard.

The White Paper’s analysis of the commensurate with income standard relies heavily upon the acceptance of a functional analysis method of allocating the income from intangibles. Rather than presenting a strong argument in support of the standard, the White Paper quickly manifests the method’s weakness, complexity, and uncertainty. Based on its use of economic theories, functional analysis appears incongruent with the arm’s length standard. The White Paper’s argument that the commensurate with income standard falls within the arm’s length standard is a thin facade, but necessary predicate, designed to promote international acceptance of the commensurate with income standard.

The awesome task of trying to apply the commensurate with income standard clouds an otherwise extremely viable theory. Domestic taxpayers’ frustration and treaty parties’ skepticism necessitate converting the presentation of the commensurate with income standard into a practical form. The Basic Variable Formula helps to clarify and in turn promote acceptance of the commensurate with income standard. The BVF’s relative straightforwardness in comparison to the White Paper’s ubiquitous abstractions provides the foundation for its domestic and international acceptance as a practical means to implement the commensurate with income standard. Rather than bombarding the players in the world market with reams of unclear regulations, the Service needs to turn its perspective towards a long-term, stabilizing approach to regulating the actions of international, commonly controlled entities.