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TRANSFER PRICING AND THE OUTSOURCING PROBLEM

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In this special report, Prof. Langbein examines amendments to the section 482 regulations proposed in the late summer of 2003. These proposals would amend the provisions of the existing regulations, promulgated in 1994, governing the ownership of intangible property and the residual profit-split method of making transfer pricing adjustments. Prof. Langbein argues that those proposed amendments weaken the structure of the transfer pricing system established by the 1994 regulations, and that they raise issues in relation to current debates about ''outsourcing'' of skilled labor, and the role of international tax policy in creating incentives to the export of skilled labor opportunities. Prof. Langbein undertakes a brief review of the background of the 1994 regulations to demonstrate that they attempted to resolve policy conflicts concerning the prevailing ''arm's length'' system of making transfer price adjustments by giving a central role to adjustments with respect to intangible property owned by different components of an integrated corporate group. Critical to that effort as a last resort is the residual profit-split method, which, Langbein asserts, in the final analysis mandates making allocations based on the relative level of intangible development costs borne by the various members of the group. He also argues that the residual profit-split method, although promulgated as an aspect of the ''arm's length'' regime, is really a form of ''modified fractional apportionment,'' a method historically identified as the polar opposite of ''arm's length.'' But Prof. Langbein also argues that this modified system, with its emphasis on intangible development costs, contributes to the ''outsourcing'' of skilled labor opportunities. At the same time, Prof. Langbein notes that the current regulations create an alternative to this use of the residual profit-split method — and that this alternative can be conceived as a kind of ''modified arm's- length'' system. Prof. Langbein argues that the availability of that interpretation of the regulations mitigates the tendency of the regulations to contribute to the outsourcing problem. But Prof. Langbein also shows that the proposed changes to the regulations governing the ownership of intangibles and the residual profit-split method destroy that alternative, thus aggravating the contribution the regulations make to the outsourcing problem. Prof. Langbein concludes that the proposals are objectionable because they intensify the outsourcing problem, while at the same time they destroy the progress made by the 1994 regulations toward rationalizing and rendering workable the ''arm's-length'' system of making transfer pricing adjustments.

Portions of this article have appeared previously in Stanley I. Langbein, ''Economic Analysis and the Regulatory Response to Multinational Group Theory and the Limitations of the Arm's Length Approach,'' in *Transfer Pricing: Economic, Managerial, and Accounting Principles, Tax Management Portfolio* 889 at A-107 (2004).

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Treasury and the IRS in late summer 2003 issued proposed amendments to the regulations under section 482 of the Internal Revenue Code.[1] The proposed regulations had two principal parts. The first is long-promised revisions to the regulations, which have stood without amendment for an unusual 35 years, governing intercompany service ''transactions.''[2] The new proposed regulations are long and elaborate and have drawn considerable criticism, principally from the affected business community, largely on the grounds that they are too restrictive. The second is a much shorter and apparently more innocent set of amendments to the regulations governing intercompany transactions in intangible property.[3] The latter has received comparatively little attention.

But the facet of the regulations that has received the greatest degree of attention from professional communities, and the facet that appears to be a ''tightening'' of the rules, on closer inspection appears to be far less significant than the second facet, more quietly announced and distinctly less restrictive. For, unlike the services regulations, the proposed amendments to the intangibles regulations affect the core of the transfer pricing system as a whole. The proposed intangibles regulations affect those regulations in a manner that weakens the structure of the entire system.

Also, the proposed intangibles regulations raise issues relating to current debates about outsourcing skilled labor and the role of international tax policy in creating incentives for the export of skilled labor. It is quite possible that the existing regulations — both the general pricing regulations and their cousin, the cost-sharing rules — encourage placing those costs in low-tax jurisdictions. That in turn means the conduct of research, experimentation, product development, market development, and marketing activities in those jurisdictions. Those activities frequently involve a frequent use of highly skilled and technical labor.

But whatever the contribution of the current regulations to the outsourcing problem, the proposed regulations would exacerbate the tendencies of the transfer pricing rules to encourage outsourcing. That is because there is one substantial reading of the current regulations that would inhibit whatever tendencies those regulations have to contribute to outsourcing — and because the proposed intangibles regulations would destroy the possibility of reading the regulations in that manner.

Those difficulties with the proposed regulations arise at least in substantial part because of limitations on the understanding of the essential operation of the transfer pricing regulations as they were amended in 1994 and of the tensions and compromises reflected by those regulations. The principal objective of this report is to clarify that understanding by reviewing the existing regulations to demonstrate how they reflected a compromise among competing views of the transfer pricing system as those views were articulated in the late 1980s and early 1990s. Once that understanding is clarified, it becomes apparent that the apparently minor changes the proposed intangibles regulations would effect lie at the core of the transfer pricing system erected by the 1994 regulations.

That exegesis also demonstrates why the 1994 structure has proved to be an imperfect one, if not an undesirable one, largely because the structure includes rules that may contribute to the outsourcing problem. And it demonstrates how the proposed intangibles rules would exacerbate whatever tendency the current rules have to contribute to outsourcing.

I. Background of the 1994 Regulations

The evolution of the transfer pricing rules is a familiar story, but it is necessary to recount it in explaining the tendencies and consequences of the current regulations and of the pending proposals concerning the intangibles rules.

A. Basic Issues and Ancient History

The fundamental issue in transfer pricing has long been seen as a contrast between two approaches historically held to be incompatible — the arm's-length standard, said to be the dominant international ''norm,'' and formula apportionment, said to be incompatible with arm's length.[4]

The arm's-length standard hypothesizes that the two (or several) components of an integrated international enterprise are separate parties dealing with each other at arm's length. The effort is to determine the ''transfer price'' that would be charged between those enterprises.

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[1]Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles, REG-146893-02; REG-115037-00, 68 *Fed. Reg.* 53447 (Sept. 10, 2003).

[2]Prop. reg. section 1.482-9. The provision would replace Treas. reg. section 1.482-2(b), which the 1994 regulations carried over from the 1968 version of the regulations, virtually without amendment.

[3]Prop. reg. section 1.482-1(d)(3)(ii)(c), Ex. 3-5, 1.482-4(f)(3)-(6), 1-482-6(c)(3)(i)(A)-(B). The three changes are, respectively, to an example of the current regulations pertaining to the use of contractual terms in determining comparability; a rule governing the ownership of intangible property; and the rules governing the residual profit-split method. As explicated within, all three pertain principally to the treatment of intangible property under the regulations.

[4]Organization for Economic Cooperation and Development, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Report of the OECD Committee on Fiscal Affairs, ''Part I — Principles and Methods, Discussion Draft,'' *Doc 94-6414, 94 TNT 133-8*; Stanley I. Langbein, ''Economic Analysis and the Regulatory Response to Multinational Group Theory and the Limitations of the Arm's Length Approach,'' in *Transfer Pricing: Economic, Managerial, and Accounting Principles, Tax Management Portfolio* 889 at A-107 (2004); Peyton H. Robinson, ''U.S. Federal Use of Formulary Apportionment to Tax Income from Intangibles,'' 9 *Tax Mgmt. Transfer Pricing Rep.* (BNA) no. 35, at 9 (Rep. Supp. Nov. 1, 2000); Brian D. Lepard, ''Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Customary International Law Using the Arm's Length Standard as a Case Study,'' 10 *Duke J. Comp. & Int'l L.* 43 (1999); Stanley I. Langbein, ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes,* Feb. 17, 1986, p. 625.

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That price is then applied to the intercompany ''transaction'' to determine what portion of the profits of the enterprise are earned by one component, and what portion is attributable to the other or others. The transfer price ordinarily is determined by finding transactions among third parties that are ''comparable'' to the hypothesized intercompany transaction: The method relies on ''external benchmarks'' and does not involve the ''direct'' measurement of the profits of the integrated enterprise under examination.

Fractional apportionment, by contrast, measures the combined profits of the integrated enterprise. The profits are broken down by ''factors,'' which are measures of the enterprise's internal operation. The most significant conventional fractional apportionment system is used by state governments. That system uses a three-factor formula, consisting of sales, payroll, and property. Thus, the profit attributed to a particular state is determined by multiplying the combined profit by a fraction. The fraction is the weighted average of the portion of the integrated enterprise's sales, payroll, and property in the state in question.

This history has been recounted elsewhere[5] and need be only briefly summarized here. International consideration of the matter first occurred in the 1920s and 1930s, when, through the work of the League of Nations, the body of nations expressed a preference for a ''separate enterprise'' or arm's-length system over a system of formula apportionment.[6] Little attention was paid to the matter until the 1960s, when the United States published an articulate set of regulations under section 482.[7] Those regulations endorsed the arm's-length idea and set forth three so-called ''transactional'' methods to implement it.

B. 1968 Regulations

1. Basic provisions. The modern approach to transfer pricing was developed by regulations finalized in 1968. Under those regulations, there were three ''methods'' for determining the price of intragroup transfers of tangible property.[8] The comparable uncontrolled price (CUP) method determined the price by the price charged in a transaction between uncontrolled parties that was ''comparable'' to the controlled, or intragroup, transaction. If no such comparables could be found, one used the ''resale price'' method (RPM), which determined the price by marking down the price charged on the ''resale'' out of the group by a profit margin, with the margin determined by the margin found among ''comparable'' resellers. If that method could not be employed, one used the ''cost-plus'' method, which determined the price by marking up the costs incurred by the producer (the seller in the intragroup transaction) by a profit margin, with the margin determined by the margin found among ''comparable'' producers selling to ''uncontrolled'' distributors. If none of the three methods could be used, the regulations permitted the use of unspecified ''fourth methods.''[9]

Those rules implemented the overall arm's-length standard — the idea was to determine intragroup prices by the prices that would be charged among independent parties acting at arm's length.[10] That standard was thought to stand in contradistinction to ''fractional apportionment'' — a method that allocated the profits of an integrated group based on the incidence of certain factors — such as sales or payroll — associated with particular jurisdictions. The states use fractional apportionment to allocate the income of a group among the various states, and they began to use it for allocations in groups that did business internationally. That provoked international controversy, the upshot of which was, in the mid-1980s, an agreement under which the states largely abandoned explicit use of fractional apportionment in allocating the profits of multinational groups.[11]

2. Difficulties: continuum prices, residual profits, and intangibles. The federal regulations encountered difficulty almost from the outset. By the mid-1980s, when the difficulties with the state methods were largely resolved,

[5]Principally in Stanley I. Langbein, ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes*, Feb. 17, 1986, p. 625. *See also* Stanley I. Langbein, ''Economic Analysis and the Regulatory Response to Multinational Group Theory and the Limitations of the Arm's Length Approach,'' in *Transfer Pricing: Economic, Managerial, and Accounting Principles, Tax Management Portfolio* 889 at A-107 (2004).

[6]*See* Mitchell Carroll, *Taxation of Foreign and National Enterprises* (volume IV) — Methods of Allocating Taxable Income, League of Nations Document No. C.425(b).M.217(b) .1933.11.A (September 30, 1933) at 67-70. *See generally* H. David Rosenbloom and Stanley I. Langbein, ''The Tax Treaty Policy of the United States,'' 19 *Col. J. Int'l Law* 359 (1983), and Stanley I. Langbein, ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes,* Feb. 17, 1986, p. 625. *See also* Michael J. Graetz and Michael O'Hear, ''The 'Original Intent' of U.S. International Taxation,'' 46 *Duke L. J.* 1021 (1997).

[7]*See generally* Notice 88-123, ''A Study of Intercompany Pricing Under Section 482 of the Code,'' 1988-2 C.B. 458, 459-60, and nn.21-24.

[8]*See* Treas. reg. section 1.482-2A(e), which sets forth the regulations in effect before the effective date of the 1994 regulations. The former set of regulations remains in force for years beginning on or before October 6, 1994.

(Footnote continued in next column.)

[9]Treas. reg. section 1.482-2A(e). The acronyms RPM and CUP are used throughout to refer to the resale price method and comparable uncontrolled price methods, respectively. No acronym is used for the cost-plus method; the acronym CPM is used later to refer to the comparable profits method, one of the methods introduced by the 1994 regulations. The other acronyms used herein are PSM, the profit-split method, also introduced by the 1994 regulations, and the RPSM, the residual profit-split method, a subspecies of the profit-split method. The initials of the methods are often similar; special care should be taken to distinguish between RPM, the resale price method, and RPSM, the residual profit-split method. It is argued here that the latter plays a central role in the compromise achieved in the 1994 regulations.

[10]*See* Treas. reg. section 1.482-1(b)(1).

[11]*See* ''Final Report of the Worldwide Unitary Taxation Working Group,'' *84 TNT 186-49.* The report was transmitted to President Reagan on August 31, 1984. *See generally* Stanley I. Langbein, ''Economic Analysis and the Regulatory Response to Multinational Group Theory and the Limitations of the Arm's Length Approach,'' in *Transfer Pricing: Economic, Managerial, and Accounting Principles, Tax Management Portfolio* 889 at A-104-105 (2004).

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it was apparent that there were major deficiencies with the regulations at the federal level, and in the Tax Reform Act of 1986 Congress directed the Treasury to undertake a study of the problem.[12] The resulting Treasury White Paper, issued in 1988,[13] identified the difficulty with the regulations then in effect as the ''continuum price problem.''[14] The starting point, from the standpoint of theory, was that integrated corporate groups do not behave ''as if'' they were separate enterprises. The form in which economic activity is organized is a function of the conditions of the market in which the activity is organized: If the conditions are appropriate for exploitation by integrated firms, the market will be dominated by those firms; if the conditions are conducive to organization through disaggregated firms, those firms will predominate. For that reason, integrated and nonintegrated organization rarely coexist in the same market, and only in unusual circumstances will one be able to find ''comparable prices.''

Similar theoretical considerations created doubts about the utility of the two other regulatory methods, the RPM and cost-plus methods. Those methods used data pertaining to the operations of one or the other components of the group, not the whole group. Methods of that kind were apt to accord a return to the examined component that was ''marginal'' in the sense that it measured the break-even point at which the component, if separate, would be induced to enter a transaction with the other controlled party. The difficulty here was that if the component ''controlled taxpayers'' were each accorded a marginal return, the sum was apt to be less than the profit of the group as a whole — leaving an unallocated ''residual.'' Thus, those methods would define not a single transfer price but a continuum of prices along which any price would be sufficient to bring all the relevant components into the transaction were the components separate. But nothing in those methods would provide any basis for selecting among the prices along the continuum.

C. Reconsideration of the Regulations

1. The White Paper and intangible property. The White Paper's solution to this problem was to propose a ''basic arm's length return'' method (BALRM), which, in the absence of comparable prices or some other readily usable external benchmark, would allocate a market return on investment to all components of the group. The White Paper recognized that this in many cases would leave an unallocated residual; the study recognized that the residual would have to be allocated but it suggested no really concrete way of making the allocation, suggesting that the matter would be left in many cases to ''judgment.''[15]

Also, the White Paper imputed a special role to intangible property in connection with transfer pricing determinations. The original regulations had set forth only primitive provisions governing allocations for the transfer or use of intangible property within the group.[16] An abiding problem with the original regulations, linked to the ''continuum price'' problem, was the problem of the ''embedded intangible'' — the problem that occurs when an intragroup transfer of a tangible product (for instance, a valuable patented pharmaceutical) carries with it a right to use an intangible (the patent for the pharmaceutical, or a trade name or other ''marketing intangible'' associated with it). The original regulations were unclear as to whether, in those circumstances, one made a single pricing evaluation regarding the transfer of tangible property (and the extent to which, if one did, the presence of the intangible had to be taken into account in determining ''comparability''), or one made a separate evaluation regarding the transfer of tangible property and the transfer of the right to use the intangible.

The White Paper expressed the view that the entire ''residual'' income was generally attributable to intangible property. Under the White Paper's BALRM method, the first step is to perform a ''functional'' analysis of ''measurable factors . . . that do not involve the use of significant intangible assets.''[17] That step leaves a ''quantity of income not yet allocated and a set of activities involving significant intangible assets not yet accounted for,'' and ''isolate[s] the income that is attributable to the significant intangible assets owned by the corporate group as a whole.''[18]

The White Paper devised several new methods of determining an appropriate transfer price for intangible property.

Commentary interceding between the White Paper and the proposal of new regulations criticized the emphasis the White Paper placed on intangible property. That criticism emphasized that ''the 'excess' income multinational and other integrated entities generate is associated with an economic condition known as 'asset specificity,''' which ''*may* involve the presence of a highly valuable, knowledge-intensive 'intangible asset,''' but which was broader, encompassing ''site-specific assets, firm-specific human capital, and intensive investment in tangible assets,'' and some ''circumstances where nothing identifiable as an 'asset' is present at all.''[19]

2. 1992 proposed regulations. The White Paper was followed in January 1992 with new proposed regulations under section 482.[20] Those new regulations embodied several innovations, some suggested by the White Paper, others not. First, the proposed regulations adopted a more ramified conception of ''comparability'' than had the original regulations, emphasizing that ''contractual terms'' and ''economic conditions'' had to be taken into

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[12]H.R. Rep. No. 426, 99th Cong., 1st Sess. 424 (1985).

[13]Notice 88-123, note 7 *supra* at 483-485.

[14]The origin of the term is in Stanley I. Langbein, ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes*, Feb. 17, 1986, p. 625, 654-69.

[15]Notice 88-123, note 7 *supra* at 485.

[16]*See* Treas. reg. section 1.482-2A(d),

[17]Notice 88-123, note 7 *supra* at 483-485.

[18]*Id.*

[19]Stanley I. Langbein, ''Transaction Cost, Production Cost, and Tax Transfer Pricing,'' *Tax Notes*, Sept. 18, 1989, p. 1391, 1398.

[20]57 *Fed. Reg.* 3571 (Jan. 30, 1992).

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account in determining comparability.[21] Those circumstances responded to criticism of the arm's-length method based on the difference between the firm and a market of open contracts as a means of organizing economic activity.

Second, the new proposed regulations adopted new methods for making allocations regarding intangible property, adopting some of the methods suggested in the White Paper.[22]

Third, the regulations adopted a new pricing method that determined the profits of a party to a controlled transaction based on the profits of a comparable entity. The proposed regulations continued to accord first priority to the CUP method, but they gave the new method equal priority with the RPM and cost-plus method. Moreover, the proposed regulations would have required that any price based on a method other than the CUP be verified by examination of data for three years — the year under examination plus the preceding and following years. That period was dubbed the ''comparable profits interval'' and represented the most complicated and most controversial feature of the proposed regulations.[23]

Fourth, the regulations adopted another new method, the profit-split method (PSM). Although new as a method explicitly recognized by the regulations, variants of the profit-split method had in fact been in use under the existing regulations as an available ''fourth method'' for many years. The new proposed regulations in fact limited the utility of the profit-split method, because they permitted it to be used only when a comparable unrelated ''group'' could be found, with the allocation of profits in such a group used as a basis for making the allocation within the tested, controlled group.

3. Final regulations. Those proposed regulations proved quite controversial. The United States's principal trading partners, who had several years earlier attacked the formulary systems of the state governments as inconsistent with international norms, suggested that the proposed regulations also were inconsistent with accepted international standards.[24] In particular, they objected to the demotion of the RPM and cost-plus methods, which had been recognized in studies published by the Organization for Economic Cooperation and Development, and to the use of the comparable profits interval, other than as a method of last resort to cross-check the results generated by other methods.[25]

During 1992, however, Treasury, the OECD, and the finance ministries of the OECD states worked quietly to resolve differences about the revisions to the transfer pricing rules. Reflecting those discussions, in January 1993 Treasury published revised proposed regulations that accommodated some of the concerns expressed by the foreign governments.[26] At about the same time Treasury issued the second set of proposed regulations, the OECD announced it was establishing a task force to revise the 1979 OECD guidelines.

That second set of proposals largely formed the basis of final regulations issued in 1994.[27] The principles reflected in those proposals and in the final regulations were adopted in substance if not in full detail by the revised transfer pricing guidelines adopted by the OECD in 1994 and 1995.[28] Those documents are the regulations in force today. Before the publication of revisions to the services and intangibles rules in mid-2003, they were not amended or revised in any substantial manner.

The final regulations represented a continuing refinement of the regulatory approach to the linked problems of the definition of comparability, continuum prices, embedded intangibles, and residual profits. The background of the treatment of those problems in the White Paper and the original proposed regulations is essential to understanding the ultimate, although ambiguous and partial, resolution of those problems in the final regulations.

II. The Final Regulations and Intangible Property

A. The RPSM and Fractional Apportionment

As indicated above, in the process of formulating the revision of the transfer pricing rules, ultimately embodied in the new U.S. regulations and the revised OECD guidelines, the problem of the ''residual'' profit came to be recognized as the central difficulty in transfer pricing. Critics of the arm's-length system suggested that fractional apportionment addressed this problem by providing a determinate way of allocating the ''residual''; and that the selection of fractions could be a way of reflecting fundamental decisions about which nations should be accorded a primary right to tax, based on the relation of the profits to the jurisdiction.

Despite those suggestions, the finance ministries of the developed nations, supported firmly by the international business community, continued to see fractional apportionment as having a ''bad name.'' At the same time, however, during that reformulation of both the U.S. and international standards, it came to be recognized that the two approaches that had traditionally been contrasted — arm's-length and fractional apportionment — were not really polar opposites, but perhaps ends of a continuum, and that most pragmatic approaches to the problem would have to incorporate elements drawn from each ideal.[29] And it came to be recognized, at least among

[21]Prop. reg. section 1.482-1(b)(1) (withdrawn).

[22]Prop. reg. section 1.482-2(d)(2)(ii) (withdrawn).

[23]Prop. reg. section 1.482-2(f) (withdrawn).

[24]The OECD established a task force to examine the proposed U.S. regulations. The task for issued a report in January 1993 critical of those regulations just days before the United States issued the revised regulations. *See 93 TNI 8-5* (Jan. 8, 1993).

[25]*93 TNI 8-5* (Jan. 8, 1993).

[26]58 *Fed. Reg.* 5263 (Jan. 21, 1993).

[27]T.D. 8552, 59 *Fed. Reg.* 34,971 (July 21, 1993)

[28]On July 11, 1994, the OECD released a draft of its task force report, *Doc 94-6414, 94 TNT 133-8.* That was virtually simultaneous with the issuance of the final U.S. regulations. The final version of the OECD report was issued in 1995.

[29]Brian J. Arnold and Thomas E. McDonnell, ''Report on the Invitational Conference on Transfer Pricing: The Allocation of Income and Expenses Among Countries,'' *Tax Notes,* Dec. 13, 1993, p. 1377; Stanley I. Langbein, ''Economic Analysis and the Regulatory Response to Multinational Group Theory and the

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experts, that any workable formulation of the arm's-length principle would have to incorporate some elements of a fractional system. For various political and policy reasons, neither the U.S. Treasury nor the finance ministries of other nations were prepared to retreat, rhetorically, from the arm's-length notion.

There was thus a tension between the professional recognition of the need to introduce at least some elements of fractional apportionment into the essentially arm's-length regime, on one hand, and the political commitment of the governments to the rhetoric of arm's length. That tension conditioned the shape of the final regulations and guidelines. Those rules carried forward from the 1968 and 1979 rules the so-called ''transactional'' methods, by which the arm's-length idea had been implemented. They adopted, as well, two new pricing methods — the comparable profits method (CPM) and the PSM. Those methods are ''profit methods'' in that they involve or may involve the ''direct'' measurement of profits of the combined enterprise.

It is regarding one feature of the PSM — the residual profit-split method (RPSM) — that the revised regulations most clearly adopted features of fractional apportionment. That method determines the allocation of profits by first allocating to all ''contributions'' to the enterprise a ''marginal'' return, and then dividing the ''residual'' based on the value of intangible property contributed by the various members of the group.[30] That value, in turn, is determined in most cases by the costs of developing the intangible property incurred by the various members of the group.[31] In effect, the RPSM is a method of fractional apportionment that uses a single allocation factor — intangible property development costs — to accomplish the allocation of combined profit.

Nevertheless, because of the political commitment to arm's length, the final regulations and guidelines went to great lengths to limit — and to the extent not limited, to obscure — the role of that quasifractional method. The rules did this in at least five ways.

First, they retained the ''transactional'' methods inherited from the 1968 rules and by the device of the ''best method'' rule denied any express primacy to the RPSM as a preferred method.

Second, within the PSM, they provided both for the RPSM and for a ''comparable profit split'' method (CPSM), under which profits are split in accordance with the split that is effected by a pair or group of unrelated parties that is ''comparable'' to the integrated group. That comparable data is rarely if ever available, but the inclusion of the CPSM in the regulations preserves the appearance that the PSM depends on ''comparables.''

Third, the RPSM itself in the first instance depends on the ''relative'' contribution of intangibles by the various components of the group, and that is determined, to the extent possible, by ''external benchmarks,'' measures of the value of the various contributed intangibles.[32] That avoids using the ''internal'' data of the group — relative intangible development costs. The external data is rarely available, but again, as in the case of the CPSM, inclusion of that possibility in the regulations preserves the appearance that even the RPSM can be made to depend on comparables.

Comparable data is rarely if ever available, but the inclusion of the CPSM in the regulations preserves the appearance that the PSM depends on 'comparables.'

Fourth, and perhaps the second most significant feature linking the RPSM to arm's length, the key premise by which the regulations meld elements of the arm's-length idea with elements of fractional apportionment is the ascription of the entire ''residual'' profit to intangible property. The arm's-length idea is implemented on the assumption that it is imputing returns to factors or inputs. Opposition to the idea posited that the ''residual'' profit cannot be determinately associated with any input, function, or factor of production, but rather was an artifact of the fact of organization form.[33] The regulatory association of the residual with intangible property lends arm's-length rationality to the notion that a quasifractional regime, using intangible development costs as a single factor, is at the same time an implementation of the arm's-length standard.

Fifth, and most important, while those other measures can be seen to an extent as ''window dressing'' designed to obscure the dependence of the final rules on data internal to the corporate group, the regulations, closely read, provided a genuinely workable way of reaching determinate results, *without* resort to the RPSM. That method still depended to some extent on internal data, and again the significant data was intangible development cost. But that data, under that reading, does not drive the allocation of the full residual, but leaves much of the residual to be allocated to the parent or home enterprise of the group.

The argument for that more limited, ''nonfractional'' means of implementing the regulations, even in the presence of high-profit intangibles, is difficult, and depends on a close reading of both the provisions of the regulations governing intangible property and the provisions governing the use of various ''pricing'' methods recognized by the final regulations. The obscurity and opacity of the provisions reflects, as stated here, the tensions between the fundamental economics of the

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Limitations of the Arm's Length Approach,'' in *Transfer Pricing: Economic, Managerial, and Accounting Principles, Tax Management Portfolio* 889 at A-118 and nn.139-140 (2004); Reuven S. Avi-Yonah, ''The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation,'' 15 *Va. Tax Rev.* 89 (1995); Reuven S. Avi-Yonah, ''The Structure of International Taxation: A Proposal for Simplification,'' 74 *Tex. L. Rev.* 1301, 1303-04 (1996).

[30]Treas. reg. section 1-482-6(c)(3)(i)(B).

[31]Treas. reg. section 1-482-6(c)(3)(i)(B).

[32]Treas. reg. section 1-482-6(c)(3)(i)(B).

[33]*See* note 19 *supra*.

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situation and the political commitments of the governments that framed the rules. Nevertheless, that option — of what is really a ''modified arm's length,'' as opposed to a ''modified fractional apportionment'' — method is the core of the distinction between the final regulations and what would have been a more radical reform.

And that option is what limits the contribution the regulations make to the ''outsourcing'' problem. It is those limits that would be reduced if not eliminated by the proposed intangibles regulations.

Despite those considerations, it is bound to be controversial to suggest, as is done here, that the regulations ultimately depend on either a ''modified'' arm's-length system or a limited form of fractional apportionment. That is because proponents of arm's length tend forcefully to argue that the arm's-length system has been carried forward intact. This section and the following section, therefore, are dedicated to demonstrating that the regulations do in fact create that kind of system.

We begin by describing the ''surface'' of the regulations, what they appear to say, and the manner in which they appear to preserve the traditional arm's-length system. It becomes apparent, however, that the regulations turn in fundamental ways on provisions governing the allocation of income from intangible property. We thus examine those provisions and their ambiguities to see how they set the stage for a system that oscillates between a ''modified arm's length'' system and a ''modified fractional'' system. We also pause to show the potentially large quantitative magnitude of the differences that can be made by the choice of the system.

In section III we examine the provisions of the regulations governing the pricing methods themselves to show how they interact with the provisions governing intangibles to create a system that is either a ''modified arm's length'' system, or a ''modified fractional'' system, and nothing else.

B. The Surface of the Regulations

1. Best method rule. The central change wrought by the 1994 regulations was the ''best method'' rule. As noted above, the 1968 regulations set forth a strict priority of pricing methods for tangible property, and the 1992 proposals had retained a priority for the CUP method over all others. The 1992 regulations also appeared to give prominence to the ''comparable profits interval,'' treating it as a check on the RPM and cost-plus methods. That feature drew the greatest degree of criticism from the OECD and foreign governments.[34]

The temporary and final regulations abrogated any priority of methods and instead provided that the method used should be ''the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result.''[35] That ''best method'' is determined on the basis of two ''primary factors'': the degree of comparability between the controlled transaction or taxpayer and any uncontrolled comparables, and the ''quality of the data and assumptions used in the analysis.''[36] The ''best method'' rule was regarded, in the aftermath of the publication of the temporary regulations, as the centerpiece of the revised temporary regulations and a replacement for the primacy of the ''CPI'' method.

2. Methods. The determination of transfer prices therefore depends on methods. Under the prior regulations, there were three pricing methods. The 1994 regulations retained those but also introduced two new methods, the CPM and the PSM. The CPM reflected the ''comparable profits'' technique suggested by the CPI of the 1992 proposed regulations, but was revised to use various ''profit indicators.'' The 1992 regulations had tested comparability by rate of return on assets, reflecting the suggestions of the White Paper; the temporary and final regulations permitted use of that ''profit indicator'' but also permitted the comparison to be made regarding various ''financial ratios,'' which include relations among operating expenses, revenue, and cost of goods sold. The PSM, too, was not the restrictive PSM of the 1992 regulations, which would have permitted use of the PSM only on the basis of the profit split among a ''comparable'' uncontrolled group of parties. That approach is again permissive but not mandatory under the final regulations, where it is called the ''comparable profit-split method.''

Also, the final regulations permit an RPSM under which the ''residual'' profit is allocated among the components of the integrated group based on their contribution of intangible property to the group. The character of the RPSM as a ''modified fractional'' technique is noted above. It plays a central role in the argument here about the final shape of the regulations and the effect the proposed changes would have on the general effect of the regulations.

3. Problems beneath the surface. The surface of the regulations is thus that there are several methods, all designed in some way in keeping with traditional arm's-length ideas, and that selection among them is simply a matter of developing data and understanding notions of comparability. In that light, too, the 1994 regulations set forth a refined and articulate definition of comparability. The new regulations emphasized five factors to be examined in determining comparability: functional analysis, risk, contractual terms, economic conditions, and property and services.[37] Those provisions descended from the original 1992 proposed regulations but were revised in the 1993 temporary regulations.

But the matter is more complicated and less straightforward, for two principal reasons. First, the ''best method'' rule is considerably less permissive than its initial statement makes it appear. The new regulations create an array of potential pricing methods, but for the regulations impose threshold ''comparability and reliability'' considerations that determine whether any given method is appropriate. As argued more fully below, those considerations will greatly limit the appropriateness of

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[34]*See* note 25 *supra*.
[35]Treas. reg. section 1.482-1(c)(1).
[36]Treas. reg. section 1.482-1(c)(2).
[37]Notice 88-123, ''A Study of Intercompany Pricing Under Section 482 of the Code,'' 1988-2 C.B. 458, 483-485.

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many or most of the methods. Thus, in most circumstances, a taxpayer will be free to choose among only a limited number of the methods described in the regulations.

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Second, and as a related point, the notion of simply choosing among methods, all designed along conventional arm's-length lines, encounters almost immediately a significant problem: intangible property. The original 1968 regulations set forth separately rules governing intercompany transfers of tangible property, on one hand, and intercompany transfers or licenses of intangible property, on the other, as if they were two separate kinds of intercompany transaction, occurring essentially in separate circumstances. The 1994 regulations followed that pattern, setting forth rules governing intercompany intangibles transactions in a separate section of the regulations.

But the most significant form of intercompany transfers of intangibles is not a set of transactions parallel to transactions in tangible property. Rather, the most significant kind of intangibles transactions occur in connection with tangible property transactions. Take, for instance, a company selling books. The books are tangible property, and they might be produced in Country A and sold in Country B; the transaction between Country A parent and Country B subsidiary is a transfer of tangibles. But the value of the books is apt to be reposed in copyrights, and those are not transferred in an ''intermediate'' intercompany transaction. The parent holds the copyright and in some sense ''licenses'' (or transfers) it to the subsidiary, but the subsidiary is not then transferring it to an unrelated party in an ultimate resale transaction, as it is in the case of the tangible books themselves.

Thus, the major problem with intangible property is the problem of the intangibles transaction ''embedded'' in a transfer of tangible property (or services), when the latter is the product ultimately sold outside the group. The 1968 regulations addressed the question in only a primitive way, if at all. The 1994 regulations gave much more complete answers.

4. Intangible property methods as 'parallels' to tangible property transactions. Still, the ''surface'' of the regulations continues to address intangible property transactions as if the transactions principally at issue were the parallel to the tangible property transactions principally at issues — that is, as if they were ''intermediate'' intercompany transactions made with a view toward ultimate resale outside the group. Thus, as in the 1968 regulations and the 1992 proposed regulations, the 1994 regulations set forth pricing ''methods'' for transactions in intangibles.

The final regulations did not adopt the methods suggested by the White Paper and the 1992 proposed regulations, but instead adopted pricing methods patterned on those governing transfers of tangible property.[38] The final regulations set forth a comparable uncontrolled transaction (CUT) method patterned on the CUP method. There is no analog in the intangibles area for the RPM or the cost-plus methods. The regulations allow the two new profits methods — the CPM and the PSM — to be used in making allocations for intangibles.

C. The Origin of Intangibles

1. General problem. At the same time the 1994 regulations set forth the rules to govern intangibles allocations as if those allocations were ''parallel'' to the allocations for tangible property, they also took far greater cognizance than had any predecessor of the fact that intangibles allocations were most frequently connected to transfer of tangibles (or of other ''intermediate'' products or services).

That was accomplished by three separate rules that addressed not *how* an allocation regarding intangibles is made, but *when* and *to whom* such an allocation is made. Those rules are scattered in the regulations — one is part of the provisions governing comparability considerations; one is part of the rules governing the ''transactional'' methods for pricing tangible property transactions; and the third is a subsidiary part of the intangibles regulation.

Those rules addressed what critics of the arm's-length system had cited as a key difficulty — the problem of ''locating'' intangible property within a group and of defining when an intercompany ''transaction'' in intangible property has taken place.[39] The regulations accomplish those tasks largely by associating the residual property not with intangible property as such, but with the costs of developing intangible property. That device ultimately links up with the provisions governing the RPSM that allocate the residual profit on the basis of the intangible development costs incurred by the parties.

2. Contractual terms and Example 3. As noted, the regulations define ''contractual terms'' as one of the factors examined in determining the comparability of controlled and uncontrolled transactions. The revised regulations provide that the ''contract'' between controlled parties be examined, but that the contract must be ''consistent with the economic substance of the underlying transactions,'' which is to be determined giving ''greatest weight . . . to the actual conduct of the parties, and the respective legal rights of the parties.''[40] It does not matter whether there exist written agreements either between the controlled parties or between the uncontrolled parties in the comparable transaction.

The first significant provision of the regulations governing the identity of the party to whom an allocation based on intangible property must be made appears as an example to the contractual-terms rule. USD, a United States corporation, is the exclusive distributor of products manufactured by FP, its foreign parent. The FP products are sold under a trade name that is not known in the United States. USD does not have an agreement

[38]Treas. reg. section 1.482-4.
[39]*See* note 19 *supra*.
[40]Treas. reg. section 1.482-1(d)(3)(ii)(B)(1).

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with FP for the use of FP's trade name. For six years, USD incurs marketing expenses promoting FP's trade name in the United States that are substantially above the level of those expenses incurred by comparable distributors in uncontrolled transactions. FP does not directly or indirectly reimburse USD for its marketing expenses. By year 7, the FP trade name has become very well known in the market and commands a price premium. At that time, USD becomes a commission agent for FP.[41]

The example states that it is unlikely that at arm's length, USD would incur those above-normal expenses without some assurance it could derive a benefit from the expenses. The regulations thus provide that those expenditures indicate a course of conduct that is consistent with an agreement under which USD received a long-term right to use the FP trade name in the United States, and that that conduct is inconsistent with the contractual arrangements between FP and USD under which USD was merely a distributor, and later a commission agent, for FP. The regulations thus conclude that the IRS may impute an agreement between USD and FP under which USD will retain an appropriate portion of the price premium attributable to the FP trade name.[42]

Although that example appears to address only the question of comparability — saying that the fact that the distributor incurred these expenses means it will not be comparable to a distributor who incurred no such expenses and has no rights to the intangible — the example also implies that USD should be compensated for that right in connection with its purchase from the parent of goods for resale.

3. Embedded intangibles. The second rule identifying the party to whom an intangible allocation must be made appears in Treas. reg. section 1.482-3, the section of the regulations that defines the three "transactional" methods (CUP, RPM, and cost-plus) used for determining the price on the transfer of tangible property.[43]

Under the regulations, an "embedded intangible" exists when the "value of an item of tangible property" is "affected by the value of intangible property, such as a trademark affixed to the tangible property."[44] The regulations then distinguish two circumstances. In the first the transfer of the tangible property does not confer on the purchaser "any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal circumstances."[45] In the second "the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property)."[46]

In the first circumstance, the transfer of the tangible property with the embedded intangible is not considered a transfer of intangible property. The embedded intangible, however, must be taken into account in evaluating the comparability of any "uncontrolled comparables." That means, presumably, that the resale of a trademarked product is generally not comparable to the resale of a nontrademarked property. In the second circumstance, however, "it may be necessary to determine the arm's length consideration" for the intangible transferred "separately from the tangible property."[47]

That rule bears three significant ambiguities. First, it may be difficult to determine *when* a transferee *has* rights to an intangible. That ambiguity pertains to Example 3 of the contractual-terms regulations as well. If a distributor has incurred the kind of expenses described in Example 3, it is unclear at what point the distributor will be determined to have constructively acquired rights to the intangible.

Second, the manner in which the embedded intangibles regulation states the rule governing circumstances in which "the recipient" *does* have rights to the intangible is potentially confusing. The regulatory rule relates to circumstances in which "the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible."[48] The question concerns what is meant by a "transfer" "conveying" the "right" in question. Again, one may refer to Example 3 of the comparability regulations. There, the reseller is held to be the owner of the right to the trademark in the country in which it distributes the product, because it has incurred costs of developing the trademark in the jurisdiction that would not have been incurred by an "uncontrolled" party.[49] In that case, when the trademarked product is transferred to the reseller by the parent (or other controlled party), is it the "transfer" that is "conveying" the right? That does not seem to be a natural reading of the language — the implication of the example is that the reseller acquired the rights by incurring the costs, and the rights were transferred (or acquired) before and apart from the tangible property transaction (of which there will presumably be many).

Third, and most importantly, it is uncertain whether, if the embedded intangible rule does not expressly encompass circumstances in which the rights are acquired by the reseller apart from the tangible property transfer, it is nevertheless suggesting that some allocation regarding the intangible owned by the reseller must be made for the intangible. It is also uncertain whether it is saying that, in those circumstances, an allocation to any controlled party that may have transferred the intangible to the reseller (in a separate transaction) should be made in connection with the tangible property transaction. And even in a transaction in which the intangible and tangible *are* transferred simultaneously, the rule in the regulations states only that a separate determination may have to be made for the transfer of the intangible, leaving a question whether there needs to be an allocation to the transferee (now the owner of a part of the intangible).

[41]Treas. reg. section 1.482-1(d)(3)(ii)(C), Ex. 3.
[42]Treas. reg. section 1.482-1(d)(3)(ii)(C), Ex. 3.
[43]Treas. reg. section 1.482-3(f).
[44]Treas. reg. section 1.482-3(f).
[45]Treas. reg. section 1.482-3(f).
[46]Treas. reg. section 1.482-3(f).
[47]Treas. reg. section 1.482-3(f).
[48]Treas. reg. section 1.482-3(f).
[49]Treas. reg. section 1.482-1(d)(3)(ii)(C), Ex. 3. *See* Part IV.B.4.e. *supra.*

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4. Ownership of intangible property. The third significant provision governing when and to whom an allocation is made for intangibles are regulations governing the identification of the owner of intangible property.

The basic rule is that if an owner of rights, to exploit an intangible transfers the rights to a controlled taxpayer, the transferor must receive consideration for the transfer.[50] The regulations also provide that if a nonowner provides ''assistance'' to the owner in connection with the ''development or enhancement'' of the intangible, the person may be entitled to consideration for the assistance.[51]

Regarding legally protected rights, the legal owner is generally considered the owner.[52] The regulations note that legal ownership may be acquired by operation of law or by a contract under which the legal owner transfers all or part of its rights. More significantly, the regulations state that the IRS may ''impute an agreement to convey legal ownership if the conduct of the parties indicates the existence of such an agreement.''[53] The statement includes a reference to the provisions of the comparability definition discussing contractual terms.[54]

Regarding rights that are not legally protected, the ''developer'' is considered the owner of the property. The developer is ''the controlled taxpayer that bore the largest portion of the direct and indirect costs of developing the intangible, including the provision, without adequate compensation, of property or services likely to contribute substantially to developing the intangible.''[55] The regulation provides that if it cannot be determined which controlled taxpayer bore the largest portion of the costs of development, all other facts and circumstances are taken into consideration, ''including the location of the development activities, the capability of each controlled taxpayer to carry on the project independently, the extent to which each controlled taxpayer controls the project, and the conduct of the controlled taxpayers.''[56]

The regulations then proceed to provide that, regarding both legally protected and unprotected property, allocations may be made to reflect an arm's-length consideration for assistance provided to the owner of an intangible in connection with the development or enhancement of the intangible.[57] The ''assistance'' may include loans, services, or the use of tangible or intangible property, but it does not include ''expenditures of a routine nature that an unrelated party dealing at arm's-length would be expected to incur under circumstances similar to those of the controlled taxpayer.''[58]

A question the regulations do not answer concerns the determination of an ''arm's length consideration'' for the assistance in question. The question is whether the allocation for assistance should be a ''marginal'' return or a ''share'' of the ''combined profit,'' based on the assistance given. If the consideration should be determined on the latter basis, the logical candidate for determining an assister's share would seem to be the intangible development costs the assister incurred — because those costs are used in determining the identity of the developer, and those costs, under the examples, are used as a basis for determining when a course of dealing among the related parties gives rise to a conclusion that one party is the ''constructive'' owner of intangible property.

Resort to the collateral provisions of the regulations governing allocations with respect to loans, services, or the use of property is not entirely helpful in this regard. Those regulations speak vaguely about an ''arm's length consideration'' without focusing specifically on whether that consideration should be a marginal return or a share of a supermarginal return.[59]

5. Fromage Frere. Those issues are illustrated by what is undoubtedly the most ''famous'' and controversial example in the 1994 regulations, the so-called cheese example.[60] It involves a foreign producer, FP, that produces cheese marketed under the trade name Fromage Frere. The company decides to enter the United States and forms a U.S. subsidiary (USSub) that incurs ''expenses that are not reimbursed by FP for developing the U.S. market for Fromage Frere,'' and are ''comparable to the levels of expense incurred by independent distributors in the U.S. cheese industry when introducing a product in the U.S. market under a brand name owned by a foreign manufacturer.'' The regulation provides that because USSub would have been expected to incur those expenses if it were unrelated to FP, no allocation to USSub is made for the market development activities performed by USSub.

The example is followed by another in which the expenses incurred ''are significantly larger than the expenses incurred by independent distributors under similar circumstances,'' in which case an allocation is made for the fair market value of the services that USSub is considered to have performed for FP.[61] In a following example, the subsidiary incurs expenses larger than those incurred by independent distributors, but the parent and subsidiary also enter into a long-term agreement under which the subsidiary receives an exclusive right to distribute cheese in the United States under the ''trademark.''[62] In that case, the example states, the subsidiary is

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[50] Treas. reg. section 1.482-4(f)(3)(i).
[51] Treas. reg. section 1.482-4(f)(3)(iii).
[52] Treas. reg. section 1.482-4(f)(3)(ii)(A).
[53] Treas. reg. section 1.482-4(f)(3)(ii)(B).
[54] Treas. reg. section 1.482-1(d)(3)(ii)(B).
[55] Treas. reg. section 1.482-4(f)(3)(ii)(B).
[56] Treas. reg. section 1.482-4(f)(3)(ii)(B).
[57] Treas. reg. section 1.482-4(f)(3)(iii).
[58] Treas. reg. section 1.482-4(f)(3)(iii).

[59] Treas. reg. section 1.482-2(b)(3) (services), (c)(2) (rental of tangible property). The existing services rules distinguish (at articulate length) between services that are an ''integral part'' of the business either the ''renderer'' or the ''recipient.'' If services are not such an ''integral part'' of the business of either, the ''arm's length charge'' is simply a reimbursement of the costs of the ''renderer'' — in other words, the ''allocation'' rule is operating primarily as a deduction allocation (or disallowance) rule. The best argument would seem to be that this provision implies that the allocation should involve a ''share'' of the profit, not just a marginal return. The implication is, however, less than overwhelming.
[60] Treas. reg. section 1.482-4(f)(3)(iv), Ex. 1.
[61] Treas. reg. section 1.482-4(f)(3)(iv), Ex. 2.
[62] Treas. reg. section 1.482-4(f)(3)(iv), Ex. 3.

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deemed to be an owner of the trademark right, and its conduct is ''consistent with that status.'' Therefore, its development activities are not considered to be a service performed for the ''developer'' or ''owner,'' whichever FP is in this case, so no allocation is made regarding that service. The subsidiary does pick up an allocation based on its ownership rights, however. The example implies that the allocation would be different from the allocation that would, in the absence of the formal agreement, have been made for the services. The regulation, however, gives no guidance on how to quantify any such difference and there is reason to question, as a practical matter, how different the outcome might prove to be.

D. The Ambiguities in Practice

The ambiguities in the embedded-intangibles and intangibles-ownership rules, and their relation to ultimate allocations and policy conflicts, are best illustrated by a simple numerical example.

We will begin with the Fromage Frere example and give it some numbers. Assume the resale price of the cheese (the revenue from the sales) is 100. Assume that FP incurs ''production cost'' of 20, and that USSub incurs ''marketing cost'' of 5. Those are costs of producing and distributing the tangible good (cheese), and are not ''intangible development costs.'' Also, assume that FP incurs allocable ''intangible development cost'' of 10 and that USSub incurs ''intangible development cost'' of 5. The total net profit, accordingly, is 60.

The ambiguity of Example 3 and the first ambiguity of the embedded-intangibles rule. Example 3 is indefinite as to when a reseller's level of expenditures is such that the reseller is deemed to have a ''long-term right.'' The first ambiguity of the embedded intangibles rule, described above, is the same question. Is the five of intangible development cost incurred by USSub enough to deem USSub to have acquired a ''long-term right'' or some other form of intangible?

The second ambiguity of the embedded-intangibles rule. This question arises if five is enough to give USSub a long-term right. The embedded intangibles rule applies if a transfer of tangible property ''conveys'' a right to the USSub. But when one has concluded that USSub has long-term rights based on the costs it incurred, is the transfer (subsequent to incurrence of the costs) of the tangible item ''conveying'' the right? The answer is no, if by ''conveying'' the right we mean the circumstances that gave rise to the (legal) conclusion under the section 482 regulations that the right existed. However, the right is useless without the tangible property transaction(s), so it is possible the transfer of the latter *does* convey the right.

That question has consequence even if we decide that the presence of the right, based on the costs incurred, requires imputing some compensation to the transferee (under Example 3 or some other provision other than the embedded-intangibles rule). For, as indicated above and noted more fully below,[63] the embedded intangibles rule appears to say that when the tangible transfer ''conveys'' the right, a separate allocation must be made to compensate the *transferor* for *its* rights — as opposed to making a combined allocation to the transferor using, perhaps, a single comparable. That consequence is independent of the question of compensation to the transferee, so the second ambiguity is of significance even if we decide that the transferee should be compensated on the basis of Example 3, the intangibles-ownership rule, or some other rule apart from the embedded-intangibles rule.

The third ambiguity of the embedded-intangibles rule. This question arises if five is enough to give USSub a long-term right and if the transfer of the tangible triggers the intangibles-ownership rule (or if the transfer of the tangible confers a right for reasons independent of the incurrence of costs). On its terms, the embedded intangibles rule seems to be saying something a little confusing — that *if* the right is transferred, a *separate* allocation regarding the intangible must be made *to compensate the transferor*. That is as opposed to making a single allocation finding a single comparable for the tangible property transaction (which necessarily would also involve transfer of an intangible), and would override use of such a comparable even if such a comparable could be found (and quite possibly even if a comparable for the ''separate'' intangibles transaction could not be found). Less clear is the question of compensation to the transferee for the ''right'' conveyed in the ''embedding'' transaction. Because the transferee now has (and may already have had) the right, does it now get compensated? Or is receipt of the right compensation enough?

The ambiguity of the intangibles-ownership rule. This is by far the most important ambiguity in quantitative terms. It assumes we are compensating USSub based on its five of development cost. Is the five a marginal return — say five plus 25 percent? Or does the expenditure entitle USSub to one-third of the residual profit, because five is one-third of the total intangible development cost?

Let us survey how those ambiguities affect a calculation of a final profit allocation. Suppose we decide that a ''marginal'' return is equal to 25 percent of costs incurred. The total profit in this situation is 60 (100 net of 40 of total cost). If we were using the RPSM, we would allocate that marginal return, in the first instance, only to the production and marketing costs, *not* the intangible development costs. That actually reflects an assumption about how the first step of the RPSM works; those regulations do not clearly mandate imputing a return to ''routine contributions'' based on costs, and also whether one separates out intangible development costs in making this imputation. On that assumption, the return to ''routine'' manufacturing operations is 20, plus a 25 percent return, or 25. The return to ''routine'' marketing operations is five, plus a 25 percent return, or 6.25.

The total return to routine operations is thus 31.25. The residual is 69.25. The residual profit is 54.25, 69.25 net of the total 15 of intangible development cost.

The next question is what, if any, return is made on account of the intangible development costs. Here we encounter the first ambiguity: Is five enough to make USSub the owner of a ''right'' and if so, does that merely affect comparability or does it require giving a return on the costs to USSub? The first question is one of degree,

[63]*See* Part III.C. *infra*.

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depending on the facts. The latter question is not answered clearly either by Example 3 or by the embedded-intangibles rules; but the intangibles-ownership rule seems to say that if five is enough to constitute ''assistance'' (regarding legally protected property) or a contribution to development of unprotected property, a return is in order.

A further question is whether the transfer of cheese, under the embedded-intangibles rules, ''conveys'' any right to USSub. A subsidiary question is whether, if we decide that the five is sufficient to confer some ''rights'' on USSub, that fact means that a right is conveyed in connection with the tangible transfer. As indicated above, the consequence of that question is that a separate allocation will have to be made regarding the 10 of intangible development cost incurred by FP. In the example given, we are going to allocate all residual profit to FP, so the resolution of that question will not ultimately make a difference. It would make a considerable difference, however, if the transferor were a ''sister'' subsidiary of USSub, so the residual allocation were going to a parent that was a party other than the transferor.

If we determine that the five is insufficient to require giving a return to USSub, then we might simply increase the revenue to USSub by five, to a total of 11.25. The transfer price would be 88.75. FP's profit would be 88.75, reduce by total cost of 30, or 58.75. The profit would be divided 1.25 to USSub and 58.75 to FP. We are assuming some pricing method other than the RPSM is used.

If the five of costs requires a return to USSub and a separate return on the intangibles to FP, we have to determine the return. That raises the question whether the return is a ''marginal'' return or a share of the residual profit. Assume it is a marginal return. Using the 25 percent figure, the return would be 6.25, and we would increase the revenue to USSub to 12.5. The profit is now allocated 2.5 to USSub and 57.5 to FP.

If it is a share of the total residual, however, we allocate one-third of the residual *profit* to USSub and two-thirds to FP. That will result in the addition of 18.25 to the 11.25 of revenue we accorded to USSub when we assumed USSub was entitled to no return on the intangible development cost. That yields a transfer price of 70. That accords 20 of profit to USSub, eight times that allocated using a marginal method. It gives an allocation of 40 of profit to FP.

The Fromage Frere example involves a foreign parent distributing product in the United States. To understand the potential effect of the transfer pricing rules on outsourcing, one must reverse the parties, assuming a U.S. parent distributing abroad. The above numbers are not unrealistic assumptions about what a typical situation involving high-profit intangibles might be. The difference between a rule giving a marginal return to intangible development costs incurred abroad and one giving a share of residual profit based on those costs is plainly significant. A rule allocating costs on the basis of residual profit clearly creates a greater potential to reduce U.S. taxes than a more limiting rule according a marginal return.

This example assumes that the RPSM does not apply. If the RPSM does apply (whether on a mandatory or a discretionary basis), then, in the outbound context, the rules favor a substantial allocation ''out'' of profits, based on relative burden of intangibles development cost, and it is difficult to contain some incentive from the regulations to outsource those costs. The full question of what kind of system the current regulations construct — a primarily fractional regime, with the RPSM at its center, or a modified arm's-length regime, using marginal returns to intangible development costs — requires an examination of the rules governing the individual pricing methods. That discussion is in the next section.

III. Pricing Methods and High-Profit Intangibles

Part II posits that the current section 482 regulations establish in effect a system that is different from the system they appear to establish. On the surface, the regulations seem to set forth a flexible, multifaceted system under the best method rule, using any of five methods, many of them reflecting the traditional concepts of the arm's-length system. In effect, the argument set forth there says the regulations really define a dual system, with two possible but contrasting approaches. One approach is ''quasifractional,'' and breaks down residual profit proportionately among components of an integrated group (and hence among countries); the other makes only ''marginal'' allocations to ''outlying'' components, assigning the lion's share of the residual to the parent or ''home'' country. The former we called a ''modified fractional'' system, the latter a ''modified arm's length'' system.

That discussion identified two features of the regulations as effecting the deviation between their apparent approach (flexible and traditional arm's length) and their effective approach (duality, with one approach heavily tilting toward fractional apportionment). The first was the complex of provisions of the regulations ''localizing'' intangible property. Those are discussed there to demonstrate the nature of the two systems the regulations seem to establish.

That discussion, however, does not really establish that the regulations deviate from their surface and create an ''effective'' system that is different from their apparent system.

The second feature of the regulations establishing that deviation is the ''reliability and comparability'' provisions of the various sections of the regulations defining the five different methods governing tangible property transfers. It is those provisions that undermine the apparent system predicated on the ''best method'' rule and replace it with the dual system described in the preceding section. That feature of the regulations, and the manner in which it effects that transformation, is discussed at length in this section.

A. Best Method Rule

At first appearance, the best method rule appears to create genuine agnosticism concerning what methods are superior to others by abolishing the priority obtained under the prior regulations and by explicitly stating there is no priority among methods.[64] On closer inspection,

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[64]Treas. reg. section 1.482-4(1)(c)(i).

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however, the regulations as a whole are not impartial among methods, and that is particularly true when high-profit intangibles are present in a multinational group. For, in the rules setting forth each particular method, the regulations state ''comparability and reliability'' considerations, and these limit the extent to which any method will be usable and create some de facto tendencies to favor one method over others. Examined as a whole, the regulations, when high-profit intangibles are involved, tend to favor one of two systems:

(1) a system under which the residual profit method (using intangible development costs as a single allocation factor) has priority; or

(2) a system under which either the resale price method or the comparable profits method, coupled with an allocation mandated by the intangibles-ownership regulation, has priority, with some residual profit allocation to the home country.

Which of the two is more favored is a critical ambiguity in the final regulations. It is an ambiguity the proposed intangibles regulations would appear to resolve, in favor of a definitely fractional system that may aggravate the outsourcing problem.

To demonstrate that, we can take the particular pricing methods in the order that was mandated under the 1968 regulations. Some of the theoretical arguments germane to the questions posed by those regulations remain relevant to the rules of the new regulations. The objective is to make two points.

The first point is that the regulations fatally undermine the ''surface'' of a multifaceted approach and include provisions that will drive most allocations when high-profit intangibles are involved toward the RPSM.

The second is that there is one — and only one — real alternative under the regulations to the RPSM in those circumstances, and that is one involving a separate allocation to intangibles giving a ''marginal'' return to intangible development costs.

Those points are necessary to understand the far-reaching significance of the proposed changes to the intangibles and RPSM rules issued in 2003.

B. Particular Methods

1. Comparable uncontrolled price. Regarding the comparable uncontrolled price method, the regulations provide that in determining whether results derived by the comparable uncontrolled price method ''are the most reliable measure of an arm's length result'' is determined by the comparability factors identified elsewhere in the regulations.[65] But they caution that, while all such factors are considered, ''similarity of products generally will have the greatest effect on comparability under this method,'' and that ''even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction,'' and therefore ''comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences.''[66] Thus, the results derived from that method ''generally will be the most direct and reliable measure of an arm's length price . . . if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made.''[67] If there are more than minor differences, the method may be used but its reliability is further reduced; if there are material product differences for which adjustments cannot be made, the method ordinarily will not provide a reliable result.

The ''comparability and reliability'' considerations regarding the CUP methods suggest that the method will not be used in too many circumstances, particularly when unique intangible property or methods are involved and when the corporate group does not simultaneously sell through controlled and uncontrolled distributors. The examples in the regulations reinforce that conclusion, generally approving the method when the seller is selling the *same* product to both controlled and uncontrolled parties and when only differences such as where title passes or the party bearing insurance and freight charges obtain.[68] When a foreign producer is selling the same product in different parts of the United States, one through controlled distributors and the other through uncontrolled distributors, the examples are qualified in the extent to which the method, even with adjustments, may be used.[69] The examples provide flatly that when a trademark is affixed in the controlled sale but not the uncontrolled sale, even if the products are physically identical, the method may not be used.[70]

For those reasons, the CUP method has had limited use under the 1994 regulations, just as it had, even as the supposed priority method, under the 1968 regulations.

Thus, the examination of the CUP rules fortifies both points noted above. First, they do not present a real alternative to the RPSM, and thus the surface of the regulations as multifaceted is undermined. Second, the CUP rules do not present a meaningful alternative to the RPSM when high-profit intangibles are present in the group.

2. Resale price. Regarding the resale price method, the regulations warn that the method is ''ordinarily'' confined to cases ''where the reseller has not added substantial value to the tangible goods by physically altering the goods before resale'' and ''is not ordinarily used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods.''[71]

The regulations proceed to state that comparability under this method, although it is dependent on all five of the factors listed in the dash-1 regulations, depends more heavily on the functional analysis, risk, and contractual terms factors than the latter two (economic conditions

[65]Treas. reg. section 1.482-3(b)(2)(i). The comparability factors are listed at Treas. reg. section 1.482-1(d)(3), discussed at Part II.B.3. *supra*.

[66]Treas. reg. section 1.482-3(b)(2)(ii).
[67]Treas. reg. section 1.482-3(b)(2)(ii).
[68]Treas. reg. section 1.482-3(b)(2)(ii).
[69]Treas. reg. section 1.482-3(b)(2)(ii).
[70]Treas. reg. section 1.482-3(b)(4), Ex. 2.
[71]Treas. reg. section 1.482-3(c)(1).

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and property and services), because a ''reseller's gross profit provides compensation for the performance of resale functions related to the product or products under review.''[72] The regulations state that comparability under the RPM ''is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method.''[73] The regulations state that resales made by the same reseller are generally to be preferred as a source of a comparable markup than resales of other resellers,[74] but add that ''significant differences in the value of the distributed goods due, for example, to the value of a trademark, may also affect the reliability of the comparison.''[75]

An example in the regulations contemplates the resale by a foreign subsidiary of a U.S. parent of a product branded with a valuable trademark that the subsidiary distributes in a foreign country. The example recites that there are five uncontrolled resellers identified as potentially comparable, but only two of the resellers sell products branded with a valuable trademark. The example states that neither of those resellers owns the trademark. The example concludes that because ''in this case it is difficult to determine the effect the trademark will have on price or profits,'' only the two resellers selling branded products may be used in constructing an ''arm's length range,'' and it suggests that the resellers are comparables with a ''significantly lower level of comparability,'' under the regulations governing the arm's-length range.[76]

Those provisions demonstrate that, in any approach to the use of the RPM, if intangibles are used by the reseller to add value to the product, generally the method should not be used. That set of rules has to be taken in connection with the rules governing comparability, Example 3, and the rules for determining ownership of intangibles.[77] Those rules mandate an analysis of the ''actual'' dealings of the controlled parties to determine whether one of them (in this case the reseller) owns (or uses) an intangible, including a right to use an intangible in a particular jurisdiction.

That rule implies generally that only a ''marginal'' profit allocation should be made under the resale price method. It also implies that the RPM will generally be of limited use when there are high-profit intangibles anywhere in the group, because, given the regulatory rules governing the ownership of intangibles and comparability, in most circumstances there will be grounds for imputing some ''ownership'' or ''use'' of the intangibles to the reseller.

Nevertheless, the resale price method has been employed with some frequency under the 1994 regulations. It will be suggested that a principal reason for that may be the opportunity to make a separate allocation regarding intangibles, even when a reseller ''owns,'' ''uses,'' or has received a ''transfer'' of intangibles. Read strictly, however, the comparability and reliability considerations recited for the RPM support the two propositions asserted above. First, because they disfavor use of the RPM when a reseller uses valuable intangibles, they do not impede resort to the RPSM. Second, to the extent the utility of the RPM depends on a separate allocation regarding intangibles, the availability of the method does not deny the uniqueness of an alternative making a marginal allocation of intangible development cost.

3. Cost-plus method. Unlike the regulations governing the RPM, the rules governing the cost-plus method do not expressly refer to the presence of valuable intangible property. The rules state simply that the method is ''ordinarily used in cases involving the manufacture, assembly, or other production of goods that are sold to related parties.''[78]

The recitation of ''comparability and reliability considerations'' regarding the cost-plus method is for the most part identical to the recitation regarding the RPM. The cost-plus rules, parroting the RPM rules, provide that ''significant differences in the value of the distributed goods due, for example, to the value of a trademark, may also affect the reliability of the comparison.''[79]

Although the regulations make no express reference to high-profit intangibles, those intangibles will interfere with the use of the cost-plus method. If there has been a transfer of intangibles, actual or constructive, within the broad terms of the regulations, then appropriate comparables will be limited to circumstances in which a similar transfer has been made, whether the proffered comparable transactions are those of the same producer or of other producers. And there will be legal questions, borne of the ambiguities in the regulatory provisions discussed in Part II.C., about separate allocations regarding intangibles.

If there has been no transfer of intangibles, actual or constructive, there will likely be difficulties finding a producer that is comparable to the producers whose costs are used in the pricing determination.

In contrast to the RPM, the cost-plus method has not been widely used. That represents a continuation of the situation under the prior version of the regulations: The cost-plus method has always been perhaps the least used of the transfer pricing methods. In part that represents its tendency to generate an allocation of the residual to the ''parent'' enterprise; in part it reflects the fact that the method focuses on the parent enterprise, and thus may be more costly or complex to use.

Nevertheless, even by the terms of the regulations, the availability of the cost-plus method does not impeach the two propositions set forth above. Because of the uncertainty of how to account for intangibles when the method is used, the method is not a real alternative to the RPSM. And, although the matter is not emphasized within because of the generally limited utility of the method, if the method is used, it will resolve itself into a method

[72]Treas. reg. section 1.482-3(c)(3)(ii)(A).
[73]Treas. reg. section 1.482-3(c)(3)(ii)(B).
[74]Treas. reg. section 1.482-3(c)(3)(ii)(A).
[75]Treas. reg. section 1.482-3(c)(3)(ii)(B).
[76]Treas. reg. section 1.482-3(c)(4), Ex. 7.
[77]Treas. reg. section 1.482-3(b)(2)(ii).
[78]Treas. reg. section 1.482-3(d)(1).
[79]Treas. reg. section 1.482-3(c)(3)(ii)(B).

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with a separate allocation, turning on the question whether a "marginal" separate allocation is permissible.

4. Comparable profits method. The rules governing the CPM, unlike those governing the RPM and cost-plus methods, appear geared to circumstances in which there is intangible property *within the group*. But, like the RPM, the CPM regulations contemplate that the single component on which the analysis focuses will be one that itself does not own or use valuable intangible property. Nevertheless, it is concerning the CPM that the question whether a separate intangibles allocation "saves" the method is most acute.

Under the CPM, the "arm's length result is based on the amount of operating profit that the tested party would have earned . . . if its profit level indicator were equal to that of an uncontrolled comparable."[80] The important question regarding the CPM is the identity of the "tested party." The tested party is the party "whose operating profit . . . can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located." That means "*in most cases* the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets *that distinguish it from potential uncontrolled comparables*."[81]

The emphasized portions of that passage distinguish the conditions set forth by the CPM rules from those set forth by the RPM rules. The latter seem to say that ownership by the single component of an intangible generally renders the method inappropriate. That passage from the CPM regulations clearly allows the component scrutinized to be one using valuable intangibles or unique assets, *so long as the uncontrolled comparables also use such property*. Of course, at least where "unique assets" are concerned, the passage is at best ambiguous and at worst internally contradictory: If the assets are *unique*, they perforce *distinguish* the component from any otherwise comparable party, unless the passage means that another party may be comparable as long as it too possesses other assets that, although different from the tested party's asset, are also "unique." For the sake of lending sense to the regulation, practitioners have assumed that the latter meaning is intended.

As to "comparability and reliability" considerations, the regulations stress that the CPM, while implicating all of the comparability factors, rests principally on the "resources employed" and the "risks assumed" factors.[82] In any event, the CPM regulations, although stressing that "functions" are still important, make "functional analysis" less significant under the CPM than it is under the RPM and cost-plus methods. The CPM regulations also state that product differences are less significant under the CPM than under the RPM and cost-plus methods; thus, under the CPM, product differences are considerably less significant than under the CUP, under which product differences are *more* important than they are under the RPM or cost-plus methods.

What is significantly different about the CPM, as opposed to the RPM and cost-plus methods, concerns circumstances in which "valuable intangibles" have been transferred to or are otherwise owned by the tested party, whether the ownership or transfer is "constructive" under the comparability and embedded-intangible rules, on one hand, or actual, on the other. Under the RPM and cost-plus methods, the regulations appear to contemplate that that circumstance is "ordinarily" fatal to the use of the methods. Under the CPM, by contrast, the method may still be used, *but one must find a comparable that has been transferred or owns intangible property in a "similar" or "comparable" manner*. That introduces a notion of "comparable uniqueness" into the regulations. As suggested above, that is a concept the coherency of which is tenuous and the intended scope uncertain.

As noted above, despite regulatory provisions that would appear to impede or disfavor its use, the RPM method has still been widely used in taxpayer transfer pricing studies. The regulatory provisions create considerably fewer impediments to the use of CPM. Nevertheless, use of the CPM, under the regulations, would still appear to be limited by the provisions of the regulations providing for "constructive" transfers of intangible property rights and those governing embedded intangible property. As with the RPM, the CPM's use appears to be greater in relation to what the regulations appear to permit. That in all likelihood reflects some of the same circumstances operating in relation to the RPM: A lenient and perhaps inconsistent approach to the rules governing constructive intangible property transfers and intangible property; the availability of the "arm's length range"; the flexibility of the comparability rules; and the ability to achieve a nonextreme result using some alternative.

It also reflects, to a considerable extent, the possibility of making a "separate" allocation regarding intangibles in connection with the use of the CPM. The apparent greater tolerance of the CPM regulations for the presence of valuable intangibles in the "tested party" render the legal question whether any such allocation is appropriate less serious in the context of the CPM.

C. Separate Intangibles Allocations

The question posed at the outset was the ambiguity of the regulations as between two "general" systems — one a largely fractional system centered on the residual profit-split method; the other a modified arm's-length system, emphasizing the use of separate intangibles allocations under the embedded intangibles and intangibles ownership rules.

The foregoing discussion of the comparability and reliability provisions of the method regulations reveals the case that the regulations establish the former system. Take a strict reading of the "method" rules, with their disfavor of methods when intangible property is present, and most intangibles situations — which means the overwhelming preponderance of most significant transfer pricing disputes — will have to be resolved under the residual profit-split method.

That is not the end of the story. The case that the regulations establish the latter, "modified" arm's-length

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[80]Treas. reg. section 1.482-5(b)(1).
[81]Treas. reg. section 1.482-5(b)(2)(i) (emphasis added).
[82]Treas. reg. section 1.482-5(c)(2)(ii).

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system, is a bit more complicated; but it is substantial. The nature of the legal questions can be demonstrated by an example.

Assume there is a U.S.-based manufacturer, Denzelburton, that produces industrial and agricultural equipment. Assume there are two lines of product in question, one of which are "standard" products marketed to industrial or agricultural enterprises on a "retail" basis, and the other of which involves "engineered" or custom products. Both lines employ valuable intangibles that embrace both "manufacturing" intangibles and "marketing" intangibles.

Assume Denzelburton does business in a foreign country, Puppetia, in both lines of business. Assume it distributes Product Line 1 through its wholly owned subsidiary, Denzelburton Puppet, S.A. (DPSA), and Product Line 2 through independent distributors. Assume also there is another manufacturer of industrial equipment, Hallitaylor, that distributes both standard and engineered products in Puppetia and that it distributes its standard products through independent distributors (these may be the same distributors used by Denzelburton for Product Line 2).

Case 1. In a first scenario, assume that there is no basis under the comparability rules for determining that Denzelburton has transferred any right to the intangibles to DPSA. In those circumstances, the RPM could be used to determine the transfer price from Denzelburton to DPSA of Product Line 1. The markup of the independent distributors on Product Line 2 would be usable as a comparable markup but *if and only if* there was no transfer of intangible rights from Denzelburton to the independent distributors. The markup of the independent distributors on Hallitaylor products would be usable as a comparable markup but *if and only if* there was no transfer of intangible rights from Hallitaylor to the independent distributors.

If there was no transfer to the independent distributors in either case, the markup on the Product Line 2 products would be the superior comparable.[83] If there was a transfer in the case of Product Line 2, but none regarding the Hallitaylor products, the markup on the Hallitaylor products would be a usable comparable. If there was a transfer regarding both, the RPM would not be available unless some other comparable could be found.

What is said here of the RPM is also true of the CPM: The CPM could be used so long as the "transfer" situation, actual or constructive, is the same for DPSA as the "tested party" and any purported comparable.

As for the cost-plus method, there is no impediment to its use as long as the "transfer" situation is the same. If the manufacturer, however — Denzelburton regarding Product Line 2 or Hallitaylor regarding its products — has transferred an intangible in one case but not in the other, the two situations are probably not sufficiently comparable to permit the use of the cost-plus method.

In that case, the question is whether any "intangible" has been "transferred," actually or constructively, to, "developed" by, or is otherwise "owned" or "used" by, the "controlled taxpayer." If the answer is no, one can use one of the single component methods. The matter does not implicate the question of separate allocations regarding intangibles.

Case 2. In a second scenario, assume that there is a basis under the comparability rules for determining that Denzelburton has constructively transferred an intangible right to DPSA regarding the Product Line 1 products. The transferred right might be a marketing intangible, such as a right to use a brand or trademark; or it might be manufacturing intangible, such as the right to "sell" under a patent in Puppetia. Presumably the right is limited to the geographic area of Puppetia.

In this case, there is a difference between the RPM and the CPM methods. Under the RPM regulations, the fact of this transfer appears to be sufficient to defeat the appropriateness of the RPM, *whether or not there has also been a transfer to the comparable*. The RPM rules say the method is not "ordinarily" appropriate if the reseller "uses" valuable intangible property, and the examples make clear that that is the case even if an offered comparable also "uses" similar property.

The CPM regulations say something similar but in a more hedged fashion. They state that the *tested party* should be the party using the "less complex" set of intangibles, and that the method is ordinarily not appropriate if the tested party uses unique assets *that distinguish* it from potential comparables. While those provisions bear ambiguities aplenty, the best reading of them would be to permit the method to go forward at least when *both* the tested party and the comparable have unique or complex assets, so long as (a) the assets are "less complex" than those held by another component of the group; and (b) there is "comparable complexity," or "comparable uniqueness" between the tested party and the comparable.

That is where potential conflict with the "embedded intangible" rule emerges.

Case 3. As in Case 2, there is a basis under the comparability rules for determining that Denzelburton has constructively transferred an intangible right to DPSA regarding the Product Line 1 products. Assume there is no comparable basis for concluding there is any transfer regarding Product Line 2 and the independent distributors.

Assume Hallitaylor has two product lines. For both, assume it has transferred rights to the independent distributors similar to the rights constructively or actually transferred by Denzelburton to DPSA. Assume for the first of the Hallitaylor lines (Product Line A) that the distributors sell the products to ultimate customers and perform all the "selling functions" performed by both DPSA (with respect to Product Line 1) and the independent distributors (with respect to Product Line 2).

Regarding the second of the Hallitaylor lines (Product Line B), the distributors do not sell the products to ultimate customers and do not perform the routine "selling functions." Instead, they sell the products (with

[83]It would probably not be appropriate to construct an arm's-length range using the two, because the markup on the Product Line 2 products would be a superior comparable to the markup on the Hallitaylor products. That is not certain, but the question is not critical to the argument here.

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no transfer of the intangible rights) to second-tier distributors, who perform the routine selling functions. Assume the total markup of the two tiers of distributors for Product Line B exceeds the markup of the single distributor for Product Line A.

The question is, which is the preferable comparable, Product Line A or Product Line B? Oddly, one has to determine which set of transactions are comparable before one can determine what methods can be used. On the surface, one would think the Product Line B results would be more appropriate, if only because those results are achieved in a ''combined'' operation, and DPSA's operations are ''comparably'' combined. But the terms of the regulations — particularly the embedded intangibles rule — would appear to direct otherwise. They direct a *separate* allocation for the transferred intangible and the tangible property. If such a separate allocation is made, it destroys the comparability with the Product A transaction, even for purposes of the CPM, while the *two* uncontrolled transactions involved in Product B supply comparables, respectively, for the two allocations directed by the embedded intangibles regulations.

Under that approach, the gross profit derived by the intermediary distributor of Product B would supply a comparable for determining a royalty, under the comparable uncontrolled transaction method, for the separate allocation with respect to the intangible deemed owned by DPSA. The results of the second-tier distributor would supply a comparable for the determination of the transfer price on the ''separate'' tangible property transaction. The determination of that latter ''price'' clearly could be made under the CPM. It is also possible that it could be performed using the RPM. The regulations permit two readings on that last question. The provision that the RPM ordinarily may not be used when the reseller uses complex intangibles may be read to preclude use of the RPM even when a separate allocation for the intangible is made. Alternatively it may be read to permit reintroduction of the RPM for the now simplified tangible property transaction left after the separate allocation for the intangible.

Case 3 illustrates the complex interplay between the embedded intangibles rule and the constructive transfer and intangible ownership rules and the ''reliability and comparability'' provision of the method rules (the RPM and CPM in particular). Case 4 examines how that interplay affects the practically most significant cases.

Case 4. As in Cases 2 and 3, there is a basis under the comparability rules for determining that Denzelburton has constructively transferred an intangible right to DPSA regarding the Product Line 1 products. Assume there is no comparable basis for concluding there is any transfer regarding Product Line 2 and the independent distributors or regarding any Hallitaylor transactions.

This is probably the case that arises most frequently in practice, at least if the circumstances of the group under examination and of the proffered comparables, are realistically understood. It is different, in this sense, than Cases 2 and 3, and possibly Case 1; those are hypothetical, and reality probably only rarely if ever approximates them.

But Case 4 is legally complex. If one takes the comparability and reliability provisions in isolation, they would appear to route the taxpayer directly to the residual profit-split method. That is because the ''tested party,'' or the reseller involved, uses complex intangibles and there is no available comparable that does so as well. That would appear to make even the CPM impermissible.

But the comparability and reliability provisions do not exist in isolation. The embedded intangibles rule says that in circumstances like these, a separate allocation is made for the intangible. And the intangibles ownership rule supplies a method of making an allocation regarding the intangible that *does not depend on a comparable or external benchmark* but rather can be determined *with reference to internal data of the corporate group* involved. That is, an allocation can be made based on the development costs incurred by the tested party/reseller. Once such an allocation is made, the resale transaction is ''hollowed out,'' and the transaction (Denzelburton's regarding product 1) is comparable to the other transactions (Denzelburton's, regarding product 2 or Hallitaylor's, regarding its products).

This is not the end of ambiguity/uncertainty. Assuming a separate allocation can be made for the intangible, and that it may be based on internal data, there is still the large question about the allocation under the Fromage Frere regulation and examples — whether the allocation is a cost-reimbursement, ''marginal'' allocation or an allocation of the full residual profit. What is significant here is that if it is the latter, this entire ''separate'' allocation exercise will result in an allocation of profit that probably approximates the allocation that would be made by direct resort to the RPSM. The exercise is significant only if a marginal allocation is mandated by the intangibles ownership regulation. If that is permissible (or required), an allocation can be made of a substantial part of the ''residual'' profit, presumably to the parent, and situs of intangible development costs loses some of the significance it otherwise has.

The *legal* argument for this second system — a ''modified arm's length'' system, as opposed to the ''modified fractional'' system relying primarily (if not exclusively) on the residual profit split — is, on the basis of the terms of the regulation, difficult. One has two difficult steps: arguing that the comparability and reliability considerations do not block a separate allocation when there is no external benchmark for the intangibles allocation; and arguing that the Fromage Frere examples mandate a ''marginal'' allocation to development costs. But the stronger argument for a second system is based on the intention of the regulations and the underlying ''international standards'' embodied in the OECD guidelines — to preserve to a maximum extent traditional ''transactional'' or arm's-length methods. Permitting that two-step allocation minimizes the extent to which resort must be had

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to the single method in the regulations that most resembles traditional fractional apportionment.

IV. The Proposed Intangibles Regulation

The proposed amendments to the regulations issued in September 2003 would make three changes of significance to the basic structure of the regulations.[84]

First, they modify Example 3 of the comparability rules in ways that blur the significance of the link between that example and the concept of intangible development cost: In place of associating all ''residual'' income with rights, they associate the income with ''nonroutine contributions,''[85] with new stress on ''activities'' and ''services.''

Second, and most significant, they amend the rules governing ownership of intangibles to eliminate the argument that a return based on costs incurred by a member of the group can be a ''marginal'' return. The new rules direct a quick resort to the residual profit-split method.[86]

Third, they amend the rules governing the residual profit split itself, so that the residual is not necessarily associated with intangible property but may be associated with any ''nonroutine'' contribution. That again weakens, indeed destroys, the necessary link of the RPSM with the idea of intangible property.

Taken together, the proposed changes accomplish two things. First, they weaken the link between the ''residual'' income and ''intangible property'' forged by the current regulations, based on the ideas of the White Paper. At the same time, to the extent there continues to be such a link, the regulations destroy any argument that the regulations permit a ''modified arm's length,'' two-step allocation process and make clear that most allocations will be made by immediate resort to the residual profit-split method.

Both policy consequences are negative. The former destroys the limited coherency of the rules introduced by the 1994 revisions of the regulations. The latter intensifies the incentives for outsourcing created by the current regulatory regime.

A. Example 3

The proposed regulations divide Example 3 of the current comparability rules[87] into three parts.

The first example (proposed Example 3) has facts that are in substance the same as those of the current Example 3, with some minor differences — in the proposed example, the United States subsidiary is called USSub, rather than USD, and instead of unidentified ''products,'' the parties are identified as selling wristwatches. There are two substantive differences: In the proposed example, the product bears a registered trademark, while in the existing example the product is sold under a valuable trade name; in the proposed example, the subsidiary is said to ''undertak[e] incremental marketing activities'' beyond those undertaken by independent distributors while in the current example the distributor is said to ''bea[r] marketing expenses'' beyond those borne by independent enterprises.

Current Regulations[a]	Proposed Regulations[b]
In determining whether an allocation of income is appropriate in Year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP throughout their relationship.	In determining whether an allocation of income is appropriate in Year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP, *and the parties' course of conduct* throughout their relationship.
It is unlikely that at arm's-length USD would incur these above-normal expenses without some assurance that it could derive a benefit from these expenses.	It is unlikely that, ex ante, *an uncontrolled taxpayer operating at arm's length would engage in marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving* a *future* benefit *from those activities.*
These expenditures indicate a course of conduct that is . . . inconsistent with the contractual arrangements between FP and USD under which USD was merely a distributor, and later a commission agent, for FP.	*USSub's undertaking the incremental marketing activities in Years 1 through 6 is* a course of conduct that is inconsistent with the *parties' attribution to FP in Year 7 of substantially all the premium return from the enhanced YY trademark in the United States market.*

[a]Treas. reg. section 1.482-1(d)(3)(ii)(C), Ex. 3.
[b]Prop. reg. section 1.482-1(d)(3)(ii)(c), Ex. 3.

A comparison (see table) of the two versions of the regulations makes clear the weakening of the link to ''expenditures,'' and the introduction of the hazier notion of ''activities'' is central to the change in the regulations.

The options available to the district director under the new regulations are more various, too. Under the current regulations, the district director is permitted to impute ''an agreement between USD and FP under which USD will retain an appropriate portion of the price premium attributable to the FP trade name.''[88] Under the proposed regulations, the district director is permitted to ''impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the YY trademark

[84]These three are apart from prop. reg. section 1.482-9, which would govern intercompany transactions in services after the effective date of the final regulations. The effect of those proposals on the general scheme of the regulations is a matter left for a later article.
[85]Prop. reg. section 1.482-1(d)(3)(ii)(c), Ex. 3-5.
[86]Prop. reg. section 1.482-4(f)(3)-(4).
[87]Prop. reg. section 1-482-6(c)(3)(i)(A)-(B).

[88]Treas. reg. section 1.482-1(d)(3)(ii)(C), Ex. 3.

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wristwatches.'' The regulations give three examples of the agreements that might be imputed:[89]

- a separate services agreement that affords USSub contingent-payment compensation for its incremental marketing activities in Years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP;
- a long-term exclusive U.S. distribution agreement to exploit the YY trademark that allows USSub to benefit from the incremental marketing activities it performed; and
- a requirement that FP compensate USSub for terminating USSub's imputed long-term distribution agreement, an agreement that USSub made more valuable at its own expense and risk.

The regulations add that a ''taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.''[90]

New Example 4 is similar to new Example 3, except that in Example 4 the foreign parent licenses manufacturing and marketing intangibles, including the trademark to the goods, to the U.S. distributor. The example states that unrelated foreign businesses license independent U.S. businesses to manufacture and market similar products in the United States, using trademarks owned by the unrelated foreign businesses. The example states that the subsidiary performs incremental marketing activities for the trademarked products, in addition to the activities required under the terms of the license agreement, and that in year 7 USSub and FP enter into a separate services agreement under which FP agrees to compensate USSub on a cost basis for the incremental marketing activities that USSub performed during years 1 through 6 and to compensate USSub on a cost basis for any incremental marketing activities it may perform in year 7 and thereafter; and revise the license agreement to increase the royalty to a level that attributes to FP substantially all the premium return from sales of the AA trademark athletic gear in the United States. The regulations provide that the district director has the same options recited in Example 3 — making clear the conception of the proposed regulations that the imputation of part of the premium to the subsidiary may be a function of a nebulous and discretionary identification of a return on ''services,'' rather than a more concrete cost-based allocation to intangible property.[91]

New Example 5 involves facts that are different from the first two examples and different from the existing example. At the same time, Example 5 suggests a more radical departure from cost- and intangibles-based allocations in the direction of a more fluid and discretionary system. In Example 5 a pharmaceutical firm incurs R&D expenses over four years, develops a valuable compound, acquires a new company that becomes a member of its consolidated group, and transfers the new compound to the new subsidiary. One would think that the allocation here would be strictly to intangible property. Example 5 directs otherwise, repeating the language of the other examples that ''the Commissioner may impute one or more agreements between Company X and Company Y consistent with the economic substance of their course of conduct, which would afford Company X an appropriate portion of the premium return from the patent rights.''[92] The example gives two alternatives:

- a separate services agreement that affords the first company contingent-payment compensation for its R&D activities in years 1 through 4, which benefited the new company by creating and further contributing to the value of the patent rights ultimately registered by the new company; or
- an imputed transfer of patentable intangible rights from the first company to the new company immediately preceding the registration of patent rights.

Again, the taxpayer is permitted to present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

B. Ownership of Intangibles

The proposed regulations would greatly simplify the rules governing ownership of intangibles.[93] The rules abolish the distinction between intangibles that are legally protected and those that are not. Instead, they provide that for either category, the owner is the ''legal owner of an intangible pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible pursuant to contractual terms (such as the terms of a license) or other legal provision.''[94] That is subject to the caveat that if ''such ownership is inconsistent with the economic substance of the underlying transactions,'' a different result obtains, with a citation to the comparability rules.[95] The proposed regulations then say that if no owner is identified under the intellectual property law of the relevant jurisdiction, or under contractual terms, including imputed terms, the legal owner is the controlled taxpayer who has ''control'' of the intangible.[96] The proposed regulations do not define ''control,'' but say that a determination of it will be based on all the facts and circumstances.[97]

The proposed regulations promote the idea of compensation for ''contributions'' by one controlled taxpayer to intangibles owned by another, but say only that the consideration is ''determined in accordance with the applicable rules under section 482.''[98] They add a reference to the embedded intangibles rule, stating that if ''the consideration for such a contribution is embedded within the contractual terms for a controlled transaction that

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[89]Prop. reg. section 1.482-1(d)(3)(ii)(c), Ex. 3.
[90]Prop. reg. section 1.482-1(d)(3)(ii)(c), Ex. 3.
[91]Prop. reg. section 1.482-1(d)(3)(ii)(c), Ex. 4.
[92]Prop. reg. section 1.482-1(d)(3)(ii)(c), Ex. 5.
[93]Treas. reg. section 1.482-4(f)(3). The rules are discussed at section II.C.3. *supra*.
[94]Prop. reg. section 1.482-4(f)(3)(i)(A).
[95]Prop. reg. section 1.482-4(f)(3)(i)(A).
[96]Prop. reg. section 1.482-4(f)(3)(i)(A).
[97]Prop. reg. section 1.482-4(f)(3)(i)(A).
[98]Prop. reg. section 1.482-4(f)(4)(i)(A).

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involves such intangible, then ordinarily no separate allocation will be made with respect to such contribution,'' but rather ''the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's length consideration in the controlled transaction.''[99]

The proposed regulations thus abolish the notion that the ''developer'' is the owner of unprotected property and the idea that the developer is the party that bore the greatest share of the costs of development. By their terms, they militate against ''separate'' allocations for assistance.

> ***The proposed regulations would greatly simplify the rules governing ownership of intangibles.***

The proposed regulations revoke the Fromage Frere examples and replace them with a set of six examples that make clear the resort to the residual profit-split method is generally to be a good deal speedier than under the current regulations. The new examples are visibly linked to the amended examples under the comparability rules. Thus, Example 2 parallels Example 3 of the proposed comparability rules. It involves a foreign producer of wristwatches, subject to a registered trademark, and a U.S. distributor that is licensed to sell the wristwatches under an agreement that requires both parties to undertake ''without separate compensation specified types and levels of marketing activities.''[100] The example does not include recitations parallel to those in the comparability example about what independent party data is available.

The example directs that the ''comparability analysis would include consideration of all relevant factors, including the nature of the intangible embedded in the wristwatches and the nature of the marketing activities required under the contract.''[101] That language would appear to exclude the possibility of making a separate ''cost-based'' allocation regarding a contribution with respect to an intangible, and then using an unrelated reseller for the ''hollowed out'' resale transaction, as suggested, under the current regulations, in relation to Case 4 above.[102] Instead, one would have to find a ''full'' comparable, which, it is suggested above, is likely to be difficult.[103]

Example 2 then states that ''if it is not possible to identify uncontrolled transactions that incorporate a similar range of interrelated elements and there are nonroutine contributions by each of FP and USSub, then the most reliable measure of the arm's length price for the wristwatches may be the residual profit split method.'' In applying the RPSM, the regulation directs that ''[t]he analysis would take into account routine and nonroutine contributions by USSub and FP in order to determine an appropriate allocation of the combined operating profits from the sale of the wristwatches and related activities.''[104]

Example 3 is rather conspicuously drawn from Example 4 of the proposed comparability rules, and Examples 4 through 6 of the intangibles-ownership rules are variants of Example 3 of those new intangibles-ownership rules. All involve a foreign producer of athletic gear that licenses manufacturing and marketing intangibles to a U.S. subsidiary. The results recited are the same as those under Example 2: The comparable must include consideration of all factors. If a transaction with all interrelated elements cannot be identified, one uses the RPSM; the RPSM takes into account all routine and nonroutine contributions.[105]

Examples 4 and 5 are the same as Example 3, except that the subsidiary undertakes certain incremental marketing activities. In Example 4 the activities are not required by agreement with the parent; in Example 5 they are. Example 4 states that because the activities do not increase the value of the intangibles owned by the parent, no separate allocation is required for them.[106] Example 5 states that the additional activities must be taken into account in determining comparability and includes language similar to Examples 2 and 3 concerning the need for ''full'' comparables and resort to the RPSM.[107]

Example 6 is similar to Example 4 and 5, except that it is the parent that undertakes incremental activities under a separate agreement and with probable benefit to the subsidiary. The example directs results that parallel those of Examples 2, 3, and 5 — a full comparable must be found; in the absence of such a comparable, resort ''may'' be had to the RPSM; the RPSM should take into account all routine and nonroutine contributions by the separate parties.

C. The Residual Profit-Split Method

A final change the proposed regulations would wreak concerns the contents of the RPSM itself. As noted above, the current regulations assimilate the residual profit left after allocation of returns on ''routine contributions'' to intangible property. In relation to theory, that is a fiction — intangible property itself should earn a marginal return; it is the fact of integration that generates the residual. The problem for transfer pricing is that that fact cannot be localized. That is the heart of the objection to arm's-length ideas.

The current regulations resolve that problem with the *ipse dixit* that the residual is allocable to intangible property. That preserves the notion that the RPSM has something to do with traditional arm's length. At the same time, the regulations provide for an allocation of the residual based on determinable quantities — external benchmarks of the value of intangibles, if there are any;

[99]Prop. reg. section 1.482-4(f)(4)(i)(A).
[100]Prop. reg. section 1.482-4(f)(4)(i)(A), Ex. 2.
[101]Prop. reg. section 1.482-4(f)(4)(i)(A), Ex. 2.
[102]*See* Part III.C. *supra*.
[103]*See* Part III.C. *supra*.
[104]Prop. reg. section 1.482-4(f)(4)(i)(A), Ex. 2.
[105]Prop. reg. section 1.482-4(f)(4)(i)(A), Ex. 3.
[106]Prop. reg. section 1.482-4(f)(4)(i)(A), Ex. 4.
[107]Prop. reg. section 1.482-4(f)(4)(i)(A), Ex. 5.

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then on the capitalized cost of intangibles; then, if necessary and feasible, on current expenditures on intangibles. That resolves by fiat the indeterminacy of the arm's-length system while preserving the fiction that the system is still arm's length.[108]

The passages in the regulations that accomplish the *ipse dixit* are worth quoting in full:

> The allocation of income to the controlled taxpayers' routine contributions will not reflect profits attributable to the controlled group's valuable intangible property where similar property is not owned by the uncontrolled taxpayers from which the market returns are derived. Thus, in cases where such intangibles are present there normally will be an unallocated residual profit after the allocation of income [to routine contributions]. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their contributions of intangible property to the relevant business activity that was not accounted for as a routine contribution.[109]

That language would be replaced by the proposed regulations with language that eliminates the *ipse dixit* and instead associates the residual profit with "nonroutine contributions." In doing so, it reintroduces both theoretical problems about what the residual is really associated with and practical uncertainty about the outcome of the use of the RPSM:

> The allocation of income to the controlled taxpayer's routine contributions will not reflect profits attributable to each controlled taxpayer's contributions to the relevant business activity that are not routine (nonroutine contributions). A nonroutine contribution is a contribution that cannot be fully accounted for by reference to market returns, or *that is so interrelated with other transactions that it cannot be reliably evaluated on a separate basis*. Thus, in cases where such nonroutine contributions are present there normally will be an unallocated residual profit after the allocation of income [to routine contributions]. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their nonroutine contributions to the relevant business activity. The relative value of the nonroutine contributions of each taxpayer should be measured in a manner that most reliably reflects each nonroutine contribution made to the controlled transaction and each controlled taxpayer's role in the nonroutine contributions. If the nonroutine contribution by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the nonroutine contribution must be made among all the business activities in which it is used.[110]

The proposed regulations would then add that "in many cases, nonroutine contributions of a taxpayer to the relevant business activity may be contributions of intangible property," and set forth provisions identical to those in the current regulations for allocating the residual when it is generated by intangible property.[111] But the damage has been done: Insoluble questions about the "origin" of the residual profit have been reintroduced, together with indeterminacy about what the outcome may be.

D. The Policy Problem

The above discussion may suggest a contradiction about the direction taken by the proposed regulations. On one hand, it criticizes the proposed regulations for eliminating an argument against the allocation of the full residual based on intangible development costs, largely on grounds that the latter kind of allocation may encourage outsourcing. On the other hand, it criticizes those regulations for restricting the allocation of the full residual based on intangible development costs, by allowing the attribution of the residual to "nonroutine" contributions.

That contradiction is more apparent than real. The major problem with the proposed regulations is that, under the current regulations, there is a *concrete legal argument* for restricting a full allocation of the residual based on intangible development costs, and thus an obstacle to the negative policy consequences of doing so. The proposed regulations plainly eliminate any such argument. Under the proposed regulations, there is another alternative to such a full allocation, but the application of the alternative is so uncertain that it is likely that taxpayers can continue to rely, and will continue to rely, on their ability to allocate the residual based on intangible development costs, and thus that the incentives to "siting" those costs in lower-tax jurisdiction will continue. That circumstance is exacerbated by the availability of defenses to an allocation under the cost-sharing regulations, a matter beyond the scope of this report.

V. Transfer Pricing and the Outsourcing Problem

The foregoing discussion, both of the essential effect of the current regulations and of the proposed changes, reveals policy considerations that are suprising in a number of respects, especially, perhaps, regarding traditional views of fractional apportionment. It is worth describing the policy context of the current regulations — and the policy conflicts that underlie the ultimate results generated by those regulations — as a backdrop to a discussion of the policy difficulties of the proposed regulations.

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[108]*See* Part II.A. *supra*.

[109]Treas. reg. section 1.482-6(c)(3)(i)(B).

[110]Prop. reg. section 1.482-6(c)(3)(i)(B)(1) (emphasis supplied).

[111]Prop. reg. section 1.482-6(c)(3)(i)(B)(2).

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A. Policy Conflicts

One may begin with the policy context of the rules ''locating'' intangible property within a corporate group — discussed in Part II.C. Those rules lay at the core of the effort of the 1994 regulations to ''preserve'' the arm's-length standard, while modernizing that standard in light of the difficulties it engendered, difficulties that focused on residual profits and high-profit intangibles.[112]

Critics of the arm's-length system — sometimes, but not necessarily, advocates of formula apportionment — argued against any effort to identify a component of an integrated group as an ''owner'' of ''intangible property,'' and indeed cautioned against the assumption that residual profits in any sense represent a return on investment in intangible property. Those critics preferred to associate the residual with the *organization form* itself, which, whether conceived as a factor of production or not, is not local to any component of an integrated group or any national jurisdiction. That critique emerged after publication of the White Paper.

But that point of view leads to some form of modified fractional system, because under those assumptions there is no way to break down the integrated profit of the group into a return from various intragroup transactions. Indeed, the critique of the arm's-length system ultimately rested on a rejection of the assumption that the return to an integrated group can be conceived as a sum of return to individual factors or functions. That point of view logically led to consideration of some form of fractional apportionment.

In its 1994-95 guidelines, the OECD explicitly rejected formula apportionment.[113] Yet the reasons for the OECD's stridency, if not for its objections, are not altogether clear. The primary objection advanced against formula apportionment is the difficulty of securing multilateral agreement on the factors that would be used.[114]

But if residual profit represents something other than a ''return'' to intangible property, then two things follow: Any effort to ''localize'' intangibles within a group will be quite difficult; and whatever basis one devises for doing so will represent, in effect, the selection of factors to be used in what is in reality a fractional apportionment system. The argument here is that that is what happens under the final regulations, to the extent they tilt toward the RPSM.

The discussion above demonstrates the first proposition: Identifying the party to whom an intangibles allocation is to be made is quite difficult. Ultimately, the final regulations — in Example 3, in the intangibles ownership regulation, and, in connection with the RPSM — consistently employ the cost of developing intangible property as the basis for ''localizing'' intangibles. The system that emerges, again to the extent it favors use of the RPSM, is a de facto fractional system using intangible development costs as a single factor.

But the final regulations — and, even more so, the OECD guidelines — fight that conclusion, and they do so, actually, as the discussion in Part III emphasizes, with some success. The fight centers around the ambiguity drawn out in the Fromage Frere example — the question whether the return imputed to development cost is only a cost-plus type marginal return or whether it must be a share of the total profit. If the latter, the characterization of the regulations as a de facto fractional system is accurate. If the former, that characterization at a minimum requires qualification, for the system really is one with two series of imputing marginal returns, followed by the imputation of a ''second-level residual'' to the group's ''home'' country (to the component that is the parent/developer/controlling party).

To understand which of those systems the final regulations represent, it is necessary to consider the legal questions reviewed in Part III to understand how the ''localization'' rules interact with the rules governing the use of the various pricing methods for tangible property. As that discussion indicates, on balance, it seems the regulations tilt primarily toward a full residual profit-split system — a de facto fractional system using intangible development costs as a single factor. But ultimately it seems that under the current regulations, the question is unanswerable. The regulations simply waver back and forth between suggesting a full fractional system and one that operates as a limitation on allocation of the residual to the parent.

That irresolution reflects the policy conflicts that lay at the core of the reconsideration of the transfer pricing problem in the early 1990s. The tendency of the regulations to mandate a full fractional system reflected the pressures on the international system, brought principally by the United States, to devise a ''tight'' allocation regime that would keep most multinational profit in the tax net of *some* nation, and would block tax avoidance. The competing tendency to mandate a modified parent-residual system reflected the pressures, brought principally by the United States's major trading partners and the multinational corporate community, to preserve the arm's-length system and something distinct from any kind of formulary system.

B. The Outsourcing Problem

The current problem concerns the selection of the single factor in the regulations. If the tax base follows intangible development costs, it stands to reason that to the extent possible those costs will be incurred where tax rates are low. That has an obvious relation to the outsourcing problem, if that problem involves the export of highly skilled jobs, on the assumption that the payroll cost of those jobs is a major component of the cost of developing intangible property. It means there is a major incentive to outsourcing created by the regulations.

It should be emphasized that whatever incentives of this kind now exist or may be created, those incentives appear to be an unintended consequence of the design of the regulations. The regulations use intangible development costs as an allocation factor (to the extent that is what they are doing), not because of any favoritism toward multinationals or any policy of permitting movable factors to control the allocation of taxable profits.

[112]The nature of this conflict, in connection with the development of the 1994 regulations, is discussed at Part II.A. *supra.*

[113]OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* 179-192 (1996).

[114]*Id.* 185.

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The selection of that ''factor,'' rather, appears to have stemmed from a desire on the part of the drafters of the regulations (and the OECD guidelines) to preserve the ''theory'' of the arm's-length system. Using those costs as a proxy for the portion of the profit attributable to a component follows logically from the association of residual profits with intangible property. If that association is faulty, there is no justification for the allocation factor, however, and whatever untoward incentive effects flow from using it become the paramount if not the sole salient characteristic of its selection.

C. Role Reversal for Fractional Apportionment

Those incentive effects, to the extent they are present, compel, at least in the short run, some reversal of roles in connection with the debate over the merits of fractional apportionment and the arm's-length standard. Business groups have always advocated the latter, as has the government and some of the ''tax reform'' community. Fractional apportionment has been advocated by the state governments and by ''tax reform'' proponents skeptical of the tax avoidance potential of arm's length.

But regarding the central ambiguity of the current regulations, and particularly to the extent those regulations create incentives for outsourcing, it may be business groups that advocate resolving the ambiguities of the regulations in ways that make the regulations a kind of ''fractional'' system. Reading the regulations to accord only a marginal return to ''intangible development costs'' inhibits the tendency to push those costs into low-cost jurisdictions.

It is in that light that the problematical character of the proposed changes to the intangibles regulations becomes apparent. Those regulations would do away with almost all of the ambiguity of the existing regulations on this question. They would make crystal clear that the regulations function as a fractional system using intangible development costs as a single factor. That might be a victory for fractional apportionment. It is difficult to see it as a victory for tax fairness or rational tax policy. It is more difficult still to see it as contributing to effective policy toward the placement of skilled labor.

D. A Summary of the Policy Issues

The foregoing demonstrates several things about the existing transfer pricing regime and about the relationship of international tax matters to the outsourcing problem that is now a matter of considerable public attention.

First, the discussion demonstrates what has been recognized by many for the better part of two decades — that the historic contradistinction between fractional apportionment and the arm's-length system no longer holds much content, that the line between the two is blurred, and that the two are better conceived as ends of a continuum than as disjunctive approaches.

Second, the discussion demonstrates how far the existing rules go — in the high-profit intangibles context, which occupies most of the area occupied by transfer pricing questions generally — toward adopting a fractional system. The core of that system is the residual profit-split method and the ''allocation factor'' employed by that method is intangible development cost.

Third, the discussion reveals a potential significant relationship between the current transfer pricing regime and export of skilled employment opportunities to developing or low-tax jurisdictions. That relationship grows out of the emphasis of the transfer pricing rules on intangible development costs. By incurring those costs in lower-tax jurisdictions, taxable profit, under the cost sharing rules or the residual profit method, can be shifted to those jurisdictions.

Fourth, the discussion reveals that the emphasis on this fractional method, in the existing regulations, is incomplete, in that substantial legal argument can be constructed for preventing the full allocation of profit entirely on the basis of intangible development costs.

Fifth, the discussion exposes a paradox, given the conventional conceptions about arm's-length and fractional apportionment. Conventionally, arm's length is conceived as a norm endorsed by the business community that restrains stringent exercise by states of their taxing power over corporate profits. But under the current regulations, the method that more resembles traditional arm's length is more protective of the fisc, while the method that is more ''fractional'' is the method that more greatly aggravates the outsourcing problem.

Sixth, and finally, the discussion exposes this paradox regarding the amendments to the ''intangibles'' regulations proposed by the Bush administration in September 2003 — that those amendments would make the system more a ''fractional'' system, but at the same time would aggravate the outsourcing problem by eliminating one weapon the government has to restrain allocations that reward outsourcing.

The emphasis throughout has been on that final point. There are few reasons why that is justified. One is that the proposed amendments are currently pending, so it is worthwhile to examine the issues presented here in the context of consideration of those amendments. A second is that an elaboration of the problem says something about the methods and motives of the current Treasury. A third is that the likely consequences of the proposed change are serious and substantial.

In reality, however, the most serious issue may be the third point identified above — the relationship between the reliance placed by the current transfer pricing regime on the situs of intangible development costs and the outsourcing problem. With or without the proposed amendments, the regulations place great stress on the circumstance of where intangible development costs are incurred. That raises the question of the extent to which that emphasis creates incentives to outsource.

The truth of the matter is that we know very little about any such relationship. There is an intuitive link: The use of the factor in the regulations plainly creates strategic profit-shifting opportunities and it would seem that moving technical employment abroad would be a key element in any effort to exploit those opportunities. But there appears to be virtually no empirical work on the question.

That is unfortunate, given the apparent importance of the question, but it is not entirely surprising. The lack of empirical evidence, indeed the lack of understanding of the issue, is a consequence of several circumstances. First and foremost is the dearth of public information about

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how transfer pricing is actually done in the decade since the adoption of the revisions to the regulations. That problem stems in considerable part from the emphasis given by the administrators to advance pricing agreements. The APA program was instituted in 1991 and has grown exponentially in recent years. When it was instituted, the government took the position that APAs were not subject to public disclosure. At the same time, the government recognized that its practice in entering APAs was a matter of public concern and in fact would have a "lawmaking" function. Early in the life of the program, the government gave some indication it would make its practices public.

But the promise of those early initiatives has not been fulfilled. In the late 1990s, the government conceded that the APAs were "written determinations" subject to public disclosure under section 6110 and prepared to make the APAs public. Congress intervened with a statutory amendment that protects the agreements from public disclosure. As a concession to the need for public disclosure of administrative practice and "lawmaking" in the area, Congress required an annual report by the IRS about the progress of the program. Those reports have been and are issued annually, but they set forth little information about the substantive standards applied in connection with APA practice.

A second reason for inattention to the link between the transfer pricing rules and outsourcing is the sheer complexity (and ambiguity) of the regulations. Empirical research needs to be performed by economists, but economists must understand the precise nature of the regulatory law to frame any kind of inquiry. The discussion above is a glimpse of how intricate and uncertain the regulations can be.

Nevertheless, the discussion above indicates that the current transfer pricing rules are probably contributing substantially to the flow of skilled employment opportunities from the United States to places like China and India. That circumstance is of considerable moment in connection with consideration of the changes to the "intangibles" regulations proposed in September 2003. But they also suggest there are defects in the entire structure erected in the mid-1990s and that it may be time to revisit some of the basic decisions made in building that structure. Thus, a new round of transfer pricing reform may be in order in the not too distant future.

CLARIFICATION

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