ANGELS ON A PIN: ARM’S LENGTH IN THE WORLD

Transactions between persons under common control are not subject to the friction of the marketplace. Since those persons have the same, or at least similar, economic interests, there is no assurance that the price at which value changes hands between them reflects a true assessment of that value. For this reason, tax systems must police these transactions to ensure that they do not distort tax liability.¹ There is also a need to provide guidance for any revisions that the policing may inspire.

Essentially, there are two ways to fulfill these closely related but independent functions. One is to disregard controlled transactions as inherently unreliable, and instead to apply a formula to the combined results flowing to commonly controlled persons from dealings with unrelated persons. The aim is to work with objectively verifiable results, and to assign an appropriate portion of those results to each of the controlled persons who contributed to them.

There is much to recommend this approach. Ultimately, it relies on the marketplace, and that seems a good thing. In addition, the combined approach holds appeal because the existence of separate but commonly controlled entities — paper persons — was artificial to a large extent in the first place. Such persons are, after all, nothing more nor less than separate pieces of paper. Finally, formulas offer the possibility, and hence the attraction, of a system that just might be administered easily. Once components of the formula are determined and the numbers of any particular taxpayer catalogued appropriately, the formula produces a tax base. It might seem that the entire process can operate on something

¹ This may be slightly different from policing the transactions to ensure that they are not used to distort tax liability. Notwithstanding the position of the section 482 regulations that “the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances,” the role of purpose in transfer pricing analysis is rather murky. Treas. Reg. § 1.482-1(f)(1)(i).
approximating automatic pilot and, questions of taxpayer bad faith aside, there would be hardly any need for case-by-case review.

On the other hand, problems arise in moving from what the marketplace yields to the assignment of a portion of that yield to a particular person and therefore a particular jurisdiction. The virtues of a formula as an abstract proposition melt away at implementation time, because any formula is, of necessity, arbitrary. If there were but a single jurisdiction in question, the problem might not overwhelm. Some formula could be negotiated, calibrated, and applied to achieve rough justice, and experience would permit, even invite, refinement. Such has been, roughly, the experience of formulas used among the several states of the United States.

The most pressing transfer pricing problems involve cross-border transactions, however, and a single jurisdiction model is not realistic in an international context. With multiple national jurisdictions legitimately seeking a slice of the tax pie, no one formula can possibly command universal respect. So this way lies cacophony, as each claimant develops an approach based on its own situation and perceptions.

One may also fear distortions in the application of a formula, but that is perhaps too pessimistic an evaluation. It is not clear that distortion is an inevitable by-product of a formula approach. Given the infinite number of candidates, the possibility of a reasonable solution cannot be ruled out. But it is emphatically not too soon to conclude that prospects for a single formula, accepted in every country (or even most), are dim. At bottom, if the formula approach has an inherent flaw, it would seem to lie there.
The world does not welcome formulas as a means of dealing with transactions between commonly controlled persons. The OECD’s Transfer Pricing Guidelines spend five full pages on the subject, commencing with the observation that “a global formulary apportionment method would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula.” There ensues a string of critiques including “the difficulty of implementing the system in a manner that both protects against double taxation and ensures single taxation”; “tax administrations would have to consider jointly how to address the potential for artificially shifting the production factors used in the formula (e.g., sales, capital) to low tax countries”; “pre-determined formulas are arbitrary and disregard market conditions”; “global formulary apportionment methods may . . . present intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction on the basis of the currency and the book and tax accounting rules of that particular jurisdiction”; etc., etc. For these and a variety of other reasons OECD members (representing virtually all developed countries) agree that “the theoretical alternative to the arm’s length principle represented by global formulary apportionment should be rejected.” In other words, “the global formulary apportionment approach would not be acceptable in theory, implementation or practice.”

It may be observed in passing that any theoretical approach to a tax problem that elicits so many and such varied criticisms must have something compelling in its favor.

But this essay is not about formula apportionment. The subject on this table is the ostensible

---

3 Id. at ¶¶ 3.64, 3.65, 3.67, 3.69, 3.74.
Sometime in the 1990s it “came to be recognized that the two approaches that had traditionally been
contrasted — arm’s-length and fractional appointment — were not really polar opposites, but perhaps ends of a
Governments and institutions that have firmly rejected formulas have opted instead for this “transactional” approach as reflected, for
every example, in the Treasury Regulations interpreting section 482 of the Internal Revenue Code;

In determining the true taxable income of a controlled taxpayer, the
standard to be applied in every case is that of a taxpayer dealing at arm’s
length with an uncontrolled taxpayer. A controlled transaction meets the
arm’s length standard if the results of the transaction are consistent with
the results that would have been realized if uncontrolled taxpayers had
engaged in the same transaction under the same circumstances (arm’s
length result).

The section 482 regulations go on at length (if at times with charming naïveté)
to describe how the touchstone of arm’s length is to be applied both to test prices and to adjust
them in transactions involving persons under common control. The OECD, for its part,
approaches elegy on the topic:

Experience under the arm’s length principle has become sufficiently
broad and sophisticated to establish a substantial body of common
understanding among the business community and tax administrations.
This shared understanding is of great practical value in achieving the
objectives of securing the appropriate tax base in each jurisdiction and
avoiding double taxation. This experience should be drawn on to
elaborate the arm’s length principle further, to refine its operation, and
to improve its administration by providing clearer guidance to taxpayers
and more timely examinations. In sum, OECD Member countries
continue to support strongly the arm’s length principle.

Sometime in the 1990s it “came to be recognized that the two approaches that had traditionally been
contrasted — arm’s-length and fractional appointment — were not really polar opposites, but perhaps ends of a
Treas. Reg. § 1.482-1(b)(1)
Id. at 1.6.
Id. at 1.14.
In truth, the arm’s-length method is hard stuff — difficult to apply certainly, but also difficult to comprehend when carefully appraised, and containing its own copious seeds of distortion. The section 482 regulations deal with many of the practical problems by assuming an abundance of factual inputs for analysis — inputs usually lacking in any real case because the requisite data is notoriously hard to find and then to mold to the facts at hand. This leads to a host of second-best solutions and adjustments of dubious quality and pertinence, in the name of retaining a degree of “comparability” to the controlled transaction. Most prominently, it has engendered an analytical method — comparable profits — that appears to range beyond “comparability” and to approach reliance on general economic theory regarding return to capital.

The OECD — irrepressible jokester that it is — maintains that “the arm’s length principle has . . . been found to work effectively in the vast majority of cases. For example, there are many cases involving the purchase and sale of commodities and the lending of money where arm’s length price may readily be found in a comparable transaction undertaken by comparable independent enterprises under comparable circumstances.” Not only is this statement amusing to anyone who has ever been charged with actually working a sophisticated transfer pricing matter; not only does it carefully select some of the (very few) fact patterns that might readily lend themselves to the method; the statement seems designed to more to foreclose dissent than to establish the viability of the arm’s-length approach.

---

8 Id. at ¶ 1.8.
9 In fairness, the OECD goes on to acknowledge that “there are some significant cases in which the arm’s length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialized goods, in unique intangibles, and/or in the provision of specialised services.” Ibid.
That approach, as the section 482 regulations say, looks to an uncontrolled model as the touchstone for testing a transaction between controlled persons and, with various modifications, for guiding any rectifications that appear needed. In other words, the glory of arm’s length lies precisely at that point where formulary apportionment is weakest — it affords the possibility of a single standard, capable of worldwide understanding and acceptance, to be applied as a substitute for the marketplace.

As far as it goes, the arm’s-length method goes fairly smoothly. It is intuitively attractive to say that tax administrations should ask what controlled persons would have done if they had not been controlled. This sounds right, sounds clear, sounds simple.

Sounds, however, are deceiving. Even if the considerable data needed for the uncontrolled benchmark were easier to come by, the arm’s-length method would deliver less than it promises. For one thing, in the absence of perfect comparables — one of the controlled persons transferring value of precisely the kind involved in the controlled transaction to an uncontrolled person under precisely the same conditions as in the transaction with the controlled person — the analytical tools at hand come up short when the question is the price that controlled persons would have paid if they had not been controlled.

This is because, in any uncontrolled transaction, there are factors at work that are not susceptible to objective, or even rational, analysis. To take a common example, when a person purchases a vehicle from a dealer (an uncontrolled situation if ever there was one), there are at play elements of relative access to information, relative desire to enter into the transaction, relative sensitivity to price, relative effects of external factors such as need, distraction, patience, taste, and countless other influences that bear upon the price at which the
transaction will in fact occur. If this were not the case, every purchase of a given type of
vehicle would be at the same price. That is clearly not the case.

Arm’s-length analysis can, at best, suggest an area, a range, in which a
transaction between uncontrolled persons would have been likely to occur. It cannot yield the
price, the single price, for the controlled transaction, and any implicit suggestion to the
contrary is a false promise.

This, however, is not a fatal defect with arm’s length. The section 482
regulations, exuding reasonableness, embrace the concept of an “arm’s-length range” — a
spectrum of prices along which a controlled transaction might have occurred if the persons in
question had been operating in the marketplace. That range can be very broad indeed, and
there is no a priori means of restricting it (though there may be arbitrary, or statistical,
approaches to facilitate the task).

More problematic, perhaps, is the realization that related persons — paper
entities controlled by the same economic interests — are related for a purpose. There is a
reason, a compelling non-tax reason, why a Japanese company that manufactures vehicles will
distribute them in the United States through a separate, wholly owned, U.S. company. It is no
accident that useful comparables cannot be found for this case. The manufacturer, like its
competitors, has concluded, not without pondering the question, that its interests are best
served by internalizing the distribution function, as opposed to outsourcing that function to an
uncontrolled party. However the factors that enter into the decision are described, whether
“synergies” or economies of integration, they are real and obviously have value to persons in

---

10 Treas. Reg. § 1.482-1(e).
the best position to assess them. That means, of course, that asking what the price would have been if the distributor and the manufacturer had not been under common control is asking, at bottom, a nonsense question. Even with the best comparables data that can be imagined, with a range of uncontrolled prices that is narrow and clear, the use of these prices to test and adjust the controlled price is anomalous. It relies upon a counter-factual standard. For this reason, the best that comparables can produce can be only marginally relevant to the question whether the price charged between controlled persons represents a distortion.

The difficulty of administering a fact-sensitive, transaction-specific set of rules using data that may not be readily available is hardly news. Nor is the more conceptual problem of pounding the square peg of an uncontrolled transaction into the round hole of a controlled one. These problematic aspects of arm’s length have been identified many times before, often at length. And, truth to tell, it is not clear that, by themselves, they outweigh the numerous defects which the OECD so gleefully itemizes with respect to formulas.

There are, however, at least three other problematic aspects of arm’s length that have, perhaps, received less attention. All three cluster around the essential ambiguity of what it means to subject controlled transactions to an arm’s-length filter. In no particular order of priority or magnitude, the problems are: (1) identifying the level, or more accurately the specific point in the course of a business transaction, at which the test of arm’s length should be applied; (2) determining whether arm’s length is to apply to one, or both, of the controlled persons whose transaction is subject to the test; and (3) choosing an appropriate remedy for a controlled transaction that might have occurred between uncontrolled persons at different terms or prices, in light of the fact that transfers of value between controlled persons are accorded
special treatment under the tax laws of many countries for the very reason that those persons are controlled. These problems combine to make application of arm’s length highly ambiguous in any concrete case and to raise serious questions about any remedy to be applied.

The arm’s-length method asks what uncontrolled persons would have done in the circumstances of the controlled transaction. But it is hardly clear when, in the steps leading up to the controlled transaction, that question is to be posed. One approach is to raise the question *ex ante*, before any transaction has been structured and when only the most general of business goals are known (and perhaps even before that). This approach may yield a completely different answer from one that accepts the general contours of the transaction as developed by the controlled parties, and simply inquires about price.

The best illustration of the issue is probably the Tax Court’s decision in Bausch & Lomb, dealing with a U.S. taxpayer who had licensed valuable technology to its wholly owned (and newly formed) Irish subsidiary and then purchased back the subsidiary’s production, for distribution in the United States.\(^\text{12}\) Although the court’s decision consumes reams of paper, the information necessary for evaluation is, simply, that the production could have been undertaken by the U.S. parent at a cost of $1.50 per unit. As a result of the transactions between U.S. parent and Irish subsidiary, the parent paid approximately $6.00 per unit, $7.50 for the property purchased less a 20 percent royalty for the subsidiary’s use of the intangible asset. The government, relying in large part on testimony from the late and very distinguished economist David Bradford, declared that the Irish subsidiary should be allowed a mark-up on its manufacturing function, but no more than that. It was indifferent whether the royalty should be increased or the price of product decreased, but it sensibly observed that, in

\(^{12}\) 92 T.C. 525 (1989).
its right mind, no business enterprise would pay substantially more for goods than the cost it would incur to make them itself.

The court concluded otherwise. It rejected the government’s analysis to the effect that the Irish subsidiary should be compared to a contract manufacturer, on the ground that the subsidiary was not guaranteed a sales outlet for its product, and thus bore a measure of risk. On this basis the court insisted that the controlled transactions had to be analyzed as structured — that is, as a license of an intangible asset from one controlled person to another, and a purchase of tangible property by one controlled person from another. The disingenuousness of the court’s reasoning is remarkable. Even assuming that, under standard legal precepts, there were two separate, if commonly controlled, persons in question, and two separate transactions, the court never seems to ask what “arm’s length” means in the factual context that was under consideration. It does not inquire into the circumstances obtaining just after formation of the Irish subsidiary — as soon as there were two controlled persons in existence — but prior to any transaction at all. It never poses the question that the government’s position fairly screams out — namely, how would a U.S. company and a stand-alone uncontrolled Irish company have dealt with each other and accomplished their purposes as of that crucial moment.

Arguably, Bausch & Lomb, with its failure to consider the level at which arm’s length should apply, also exhibits the second problematic issue identified above with respect to arm’s length — whether the test should be applied to each of the controlled persons, or only to one of them. Certainly a fatal flaw in the court’s reasoning is that, whatever the risk borne by
the Irish subsidiary, the transaction as analyzed by the court made little sense for the U.S. parent.

The two problems, however, seem distinct. It would be possible to conceive of a transfer pricing analysis that takes account of the situation of each controlled person, independently of others, but which begins with the transaction as crafted by the controlled persons. The decision in Bausch & Lomb might then have been different, but it is not clear that the government’s contract manufacturing position would have prevailed.

The section 482 regulations, issued after Bausch & Lomb, state that “the district director will evaluate the results of a transaction as actually structured by the taxpayer unless its structure lacks economic substance.” The regulations go on to say, however, that the district director “may consider the alternatives available to the taxpayer in determining whether the terms of the controlled transaction would be acceptable to an uncontrolled taxpayer faced with the same alternatives and operating under comparable circumstances.” An example in the regulations, which seems drawn from the facts of Bausch & Lomb, concludes that the fact that a parent company “could have manufactured product X” may be taken into account in determining arm’s-length consideration in a license and sale situation. The regulation and accompanying example seem intended to place the overarching Bausch & Lomb issue in controversy again, using a more sophisticated view of what “arm’s length” means. Of course, it is too early to venture a guess whether that view will prove acceptable in the courts.

On the question whether arm’s length should be a one-sided, or a two-sided, affair, the regulations seem to favor a one-sided approach. Certainly this is the approach taken

---

14 Ibid.
with respect to the comparable profits method, for which the regulations state that there is but one “tested party.” This “will be the participant in the controlled transaction whose operating profit attributable to the controlled transactions 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.” There is no call for a “sanity check” from the viewpoint of the other party to the transaction. Thus, the conclusion that the “level of inquiry” and the “two-sided analysis” are separate and distinct ambiguities in the pursuit of arm’s length receives some confirmation here.

The third problem with arm’s length is more basic still. Whatever else can be said about controlled transactions, by definition they take place between persons having common economic interests. Transactions in which value passes between uncontrolled persons are generally (if not invariably) viewed by an income tax system in one way: value is received in return for taxable value. But that is not the case with transactions between controlled persons. A parent company may sell fishing poles to its subsidiary company. But it may just as easily contribute the poles to the subsidiary’s capital on a tax-free basis, or it may distribute them to its parent company without an expectation of value to be received in return. Controlled persons often deal with each other in these ways; it is not inevitable that their transactions have current tax consequences, because many developed tax systems refuse to see a point of taxation — a recognition event — for a disposition of value when the value remains within the economic group.

This, of course, reflects a basic contradiction in the tax laws. The rules relating specifically to transfers of assets from one company to another, commonly controlled,

\[\text{Treas. Reg. § 1.482-5(b)(2)(i).}\]
company express a judgment that persons under common control, however the concept is
defined, are not economically distinguishable from each another. It is not easy to reconcile
that principle with “arm’s length,” which posits that each controlled person should be
analogized or compared to one that is not controlled.

Take, for example, a transaction in which a parent company sells fishing poles
to its subsidiary for 25 when the poles have a provable value of 35. The natural reaction, the
reaction of most interpreters of the arm’s-length method, would be that the parent company’s
income should be adjusted upward, and the subsidiary’s downward, to reflect a price of 35
rather than the reported 25. But that is hardly the only way to look at the transaction. If
instead of a sale the parent had declared that it was contributing the fishing poles to the capital
of the subsidiary in return for additional (and probably notional) shares of stock there would be
no tax, no transfer pricing inquiry, no adjustment. Yet what is it that differentiates the sale at
25 from the outright contribution? The most distinguishing feature is probably the specific
terms under which the transactions occurred. If that is indeed the distinction, however,
suppose the relevant documents state that the parent company is transferring 25 worth of poles
to the subsidiary in return for 25 and that, if the group of poles is found to have a value in
excess of 25, the difference is intended as a contribution to capital. Can it be that such an
expression of intent, carefully drawn and clearly expressed, is sufficient to avoid a transfer
pricing adjustment?

The point was approached, but not quite reached, in the Tax Court’s decision in
Central de Gas de Chihuahua.\footnote{17} A Mexican company had allowed a sister Mexican company
to use certain assets (tractors and trailers) without compensation, and the assets had been used
to some extent in the United States. The IRS asserted a right to adjust the income of, and impose tax on, the first company. That company argued that the “excess” value should be viewed as a “constructive dividend to the [Mexican] parent of . . . [the two companies] and a nontaxable contribution of capital to petitioner.” 102 T.C. at 521. For this proposition the taxpayer cited Revenue Ruling 78-83.18

The ruling involved a diversion of income from one foreign subsidiary (“X”) of a domestic company to a foreign sister company (“Y”). Payment for goods sold by X were directed to Y, which had performed certain incidental services for X but nothing of such value as to justify the funds it received. The reason for the deflection of income was that Y was not subject to the same kinds of monetary restrictions as X. The ruling declared that “where an allocation is made under section 482 as a result of an excessive charge for services rendered between brother-sister corporations, the amount of the allocation will be treated as a distribution to the controlling shareholder with respect to the stock of the entity whose income is increased and as a capital contribution by the controlling shareholder to the other entity involved in the transaction.” In other words, the Internal Revenue Service took the view that income of X should be increased (with no immediate U.S. tax consequences, since X was foreign and there is no indication of any possible U.S. liability with respect to its income), and thereafter a distribution to the U.S. parent company, potentially taxable as a dividend, should be deemed to occur, followed by a deemed contribution to the capital of Y. These deemed steps would “explain” the existence of value in the hands of one controlled person (Y) when arm’s-length analysis indicated that the value should reside in the hands of another controlled person (X).

18 1978-1 C.B. 79.
The Chihuahua taxpayer effectively made a “sauce for the goose” argument. Value that, according arm’s-length doctrine, should have come to rest in its hands was, instead, in the coffers of its sister company, which had not paid for the assets it had used. If the government could propose a series of deemed transactions to rationalize a misplacement of value in Revenue Ruling 78-83, perhaps the taxpayer could make a similar assay.

Judge Tannenwald, however, responded as follows:

. . . the ruling . . . does not apply to the instant situation. The facts of that ruling were that sums due one subsidiary were actually paid to another subsidiary. Thus, there was an actual transfer of property, which is the hallmark of cases involving both the allocation of intercorporate payments and the consequent presence of a constructive dividend.19

This explanation does not explain much, and it certainly does not come to grips with the taxpayer’s point which, admittedly, was neither clearly articulated (at least by Judge Tannenwald) nor clearly supported by the authority on which it relied.

Revenue Ruling 78-83 deals with what the section 482 regulations refer to as “conforming adjustments.”20 These are adjustments to the tax accounts of commonly controlled persons involved in a transaction subject to a transfer pricing adjustment so that the accounts reflect real world economics after the adjustment has been made. Since the transfer pricing adjustment is for tax purposes only, and does not effect a movement of real value, it is necessary to construct a coherent tax “story” to show how the value comes to be where it is, notwithstanding the adjustment. In the ruling, for example, the value — the price paid for goods sold by X — was plainly in the hands of Y. The “story” told by the ruling is that the value found its way into the hands of Y through deemed migrations, and in the context of the

---

19 102 T.C. at 521.
20 Treas. Reg. § 1.482-1(g).
group in question the logical migrations were by way of a deemed distribution to the parent company and a deemed contribution by the parent to Y.

The important point is that the conforming adjustment comes after the transfer pricing adjustment, and is meant to offset the effects of the latter adjustment which, after all, is a pure tax construct. Since the transfer pricing adjustment deems income to move from one controlled person to another, it is necessary to adopt a countervailing, and equally constructive, movement back to where the value, in reality, is located.

This cannot be what the taxpayer in Chihuahua had in mind, because a conforming adjustment on its facts would not have given it any advantage. The issue in Chihuahua involved an adjustment under section 482 under which income was deemed paid by the company that used the assets to the taxpayer. By the time any conforming adjustment entered the picture, tax liability would have been triggered. A conforming adjustment similar to the one discussed in Revenue Ruling 78-83, involving a deemed distribution to and contribution by the Mexican parent company, would have had no further tax effect. This was a very different situation from the one in the ruling, where the conforming adjustment, and not the initial transfer pricing adjustment, gave rise to potential U.S. tax liability.

Furthermore, if it is true, as Judge Tannenwald said, that the Chihuahua taxpayer argued in favor of a constructive dividend to the parent company and “a nontaxable contribution of capital to petitioner,” then either the taxpayer or Judge Tannenwald was very confused. The person that had made value available to a commonly controlled person was the taxpayer, when it allowed its assets to be used by a sister company. It is hard to see how a contribution to the capital of the taxpayer by the common parent could possibly explain the

21 102 T.C. at 521 (emphasis supplied).
state of affairs existing after the transfer pricing adjustment. That adjustment was a deemed transfer of income (but no real value) to the taxpayer. The value was in the hands of the sister company, which had not paid for the assets it used.

Thus, Revenue Ruling 78-83 did not support the taxpayer’s position and that position, as summarized by Judge Tannenwald, made little sense. There was, however, a slightly different form in which a more persuasive argument could have been cast. If the taxpayer had been viewed as distributing value to the common parent and the latter had then been viewed as contributing that value to the capital of the sister company, there would have been no U.S. tax liability for anyone. This represented, in effect a tax-free alternative way of seeing the facts, leaving no room for any possible transfer pricing adjustment. It should not matter that the value in the case (unlike Revenue Ruling 78-83) was represented by a use of property rather than an “actual transfer of property,” since a use represents value in the same way as the property itself.

The taxpayer’s argument would thus have thus been as follows: use of the assets was distributed by the taxpayer to the common parent as a distribution not reached by U.S. tax laws, and then transferred to the sister company by the parent as a nontaxable contribution to capital. It is true that uncontrolled persons would not and could not have engaged in such a transaction because such persons would not transfer value between themselves without an expectation of value received in return and, for that reason, such persons are not subject to the rules that envision tax-free transfers of value among commonly controlled persons. Controlled persons could have engaged in precisely the described
transaction, however, if they thought about it, planned their steps, and provided ample and clear documentation.

The ultimate point is that there is a fundamental ambiguity in each and every transfer pricing situation. By hypothesis, the situation involves persons under common control and can be structured, and therefore reasonably analyzed, in either of two ways: as a failed taxable transaction, calling for adjustment to the income of the transferor; or as a transfer of value between related persons, subject to the special rules that pertain to such transfers.

Chihuahua was a triangular case, involving brother/sister companies and a common parent, but that does not distinguish it from any other transfer pricing case. All can be viewed either through the filter of arm’s length or, it would appear, in the context of the rules that relate exclusively to entities under common control. There is no obvious reason why one set of rules rather than another should prevail, and the choice might be said to turn on what the parties have expressed as their intention. But if the parties take care to express such intention in a way that allows no room for analysis other than under the latter set of rules, there would seem to be little for arm’s length analysis to do. Can it be that transfer pricing adjustments are stymied so simply?

The foregoing comments are not meant as a repudiation of arm’s length. Rather, they are meant to raise a question: what does this apparently simple concept mean? As a method for dealing with transactions between commonly controlled persons, arm’s length suffers from serious flaws not only of a practical nature but in theory, concept, and methodology. Given the potential that arm’s length holds for controversy, resource-consumption, and cost, it is hard to believe that its quirks and defects will remain so little
discussed for much longer — or that a renewed and more forthright scrutiny of arm’s length in
light of any and all conceivable alternatives will be much longer in coming.

H. David Rosenbloom
Caplin & Drysdale, Chartered
Washington, DC
March 22, 2005