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COST SHARING AGREEMENTS & THE ARM'S LENGTH STANDARD: A MATTER OF STATUTORY INTERPRETATION?

By

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"'When I use a word,' Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean—neither more nor less.'

'The question is,' said Alice, 'whether you can make words mean so many different things.'"[1]

–LEWIS CARROLL, THROUGH THE LOOKING-GLASS

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1. LEWIS CARROLL, ALICE'S ADVENTURES IN WONDERLAND AND THROUGH THE LOOKING-GLASS 164 (1898) [hereinafter CARROLL, ALICE'S ADVENTURES IN WONDERLAND].

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I. INTRODUCTION

A zeitgeist's collective momentum is curious. The arm's length standard has been the touchstone of international transfer pricing and Code section 482 for the better part of a century, but its relevance is under scrutiny. As evidenced by the Organisation for Economic Co-operation and Development's (OECD's) Base Erosion & Profit Shifting policy proposals (BEPS),[2] a growing consensus among the international community suggests the arm's length standard is no longer adequate to accurately and fairly tax the multinational enterprises (MNEs) that make up the modern global economy. *Xilinx, Inc. & Subsidiaries v. Commissioner of Internal Revenue* (*Xilinx I*),[3]

2. *See* OECD, ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013), http://dx.doi.org/10.1787/9789264202719-en [hereinafter OECD, ACTION PLAN]. For a general explanation, see OECD, BEPS PROJECT (2014), http://www.oecd.org/ctp/strategy-deepening-developing-country-engagement.pdf, which provides that:

> Base erosion and profit shifting (BEPS) is a global problem which requires global solutions. BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. BEPS is of major significance for developing countries due to their heavy reliance on corporate income tax, particularly from multinational enterprises (MNEs).

See also Susan C. Morse, *The Transfer Pricing Regs Need a Good Edit*, 40 PEPP. L. REV. 1415, 1435–36 (2013); Yariv Brauner, *What the BEPS?*, 16 FLA. TAX REV. 55, 58 (2014) [hereinafter Brauner, *What the BEPS?*].

3. Xilinx, Inc. & Subsidiaries v. Commissioner, 125 T.C. 37 (2005) (hereinafter *Xilinx I*).

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Xilinx, Inc. v. Commissioner of Internal Revenue (*Xilinx II*),[4] and *Xilinx, Inc. v. Commissioner of Internal Revenue* (*Xilinx III*),[5] which drastically narrowed the IRS's definition of the arm's length standard, foreshadowed these concerns.[6]

In *Xilinx III*, the Ninth Circuit held that allocating "all costs" in a cost sharing arrangement[7] is irreconcilable with the arm's length standard if unrelated parties would not agree to share these costs.[8] In holding for the taxpayer, the court found this departure from the arm's length standard frustrated the purpose of "parity between taxpayers in uncontrolled transactions and taxpayers in controlled transactions."[9] Thus, the court's ruling could potentially invalidate any regulations conflicting with the arm's length standard as contrary to the spirit of section 482.[10] This possibility signifies a remarkable shift in the U.S. transfer pricing landscape.

My conclusion is that both the Ninth Circuit and the IRS are incorrect: the arm's length standard should function as a legal principle, with explicit exceptions, rather than as a legal rule. I propose that income within these explicit exceptions could be allocated using flexible or limited formulary apportionment, creating a hybrid formulary-arm's length system.

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4. Xilinx, Inc. v. Commissioner, 567 F.3d 482, 489 (9th Cir. 2009), *rev'g and remanding* 125 T.C. 37, 2005 WL 2082798, *withdrawn*, 592 F.3d 1017 (9th Cir. 2010) (hereinafter *Xilinx II*).

5. Xilinx, Inc. & Subsidiaries v. Commissioner, 125 T.C. 37 (2005), *rev'd*, 567 F.3d 482 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010), *aff'd*, 593 F.3d 1191 (9th Cir. 2010) (hereinafter *Xilinx III*).

6. *See generally* Edward B. Dix, *From General to Specific: The Arm's-Length Standard's Evolution and Its Relevancy in Determining Costs to Be Shared in Cost-Sharing Agreements*, 64 TAX LAW. 197, 199 (2010) (arguing "a more appropriate basis for the Ninth Circuit's holding of May 2009 would take notice of the evolution of the arm's-length standard and recognize that, as it has developed, the standard has come to comprise an enumerated set of specific, formulary methods") [hereinafter Dix, *From General to Specific*].

7. *See* Reg. § 1.482–7(d)(1) (1995) (requiring that CSAs include "all costs").

8. *See Xilinx I*, 125 T.C. 37, *aff'd sub nom.*, *Xilinx III*, 598 F.3d at 1194; *recommendation regarding acq.*, IRS *action on dec.*, 2010-03 (Jul. 28, 2010); *acq. in result*, IRS Announcement Relating to: Xilinx, Inc., 2010-33 I.R.B. 240 (Aug. 16, 2010).

9. *Xilinx III*, 598 F.3d at 1196; *see also* Marc M. Levey & Brian P. Arthur, *Cost Sharing Developments in the U.S.: the Arm's Length Standard After* Xilinx *and* Veritas, 21 J. INT'L TAX 20, 26 (2010) [hereinafter Levey & Arthur, *Cost Sharing Developments in the U.S.*].

10. *See, e.g.*, Philip D. Morrison, Xilinx Inc.—*The Ninth Circuit Changes Its Mind*, 39 TAX MGMT. INT'L J. 335, 335 (2010); Levey & Arthur, *Cost Sharing Developments in the U.S.*, *supra* note 9, at 28.

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Part I provides a brief overview of transfer pricing and the evolution of the arm's length standard. Because transfer pricing is a legal fiction, it diverges significantly from economic reality. An increasing lack of comparable uncontrolled transactions exacerbates this discrepancy. Moreover, the arm's length standard is failing in its duty to ensure taxpayer parity because it neglects to adequately tax MNEs' residual income. Part II summarizes the *Xilinx* case history, beginning with the Tax Court's decision in 2005 and ending with the Ninth Circuit's 2010 reversal of its own 2009 holding. Part III discusses implications of the Ninth Circuit reversal. I then propose supplementing the existing transfer pricing framework with flexible or limited formulary apportionment in transactions particularly ill-suited to the arm's length standard. Finally, my conclusion argues the complexity of section 482's regulations promotes arbitrage and gamesmanship while forcing the IRS to maintain strained claims of regulatory consistency.

II. BRIEF OVERVIEW OF TRANSFER PRICING

A. *Transfer Pricing & Evolution of the Arm's-Length Standard*

Before addressing the specific issue present in *Xilinx*, it is important to provide the necessary history and background. Today's elaborate transfer pricing regime and Treasury Regulations stem entirely from section 482. Intended to prevent abusive transfer pricing practices, section 482's language authorizes the Commissioner to make allocations as necessary to prevent tax evasion or clearly reflect income:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property . . . the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.[11]

11. I.R.C. § 482.

Because the statute does not prescribe a standard for these purposes, "arm's length" has become the touchstone for evaluating the propriety of prices paid in transactions between related entities.[12]

The arm's length standard aims to establish the price related parties would have agreed to for the sale of goods or services if they had dealt with one another at "arm's length"—that is, as a negotiation between unrelated parties in the same circumstances. However, the arm's length language is not included in section 482 or its 1928 predecessor, section 45.[13] The legislative history clearly indicates the intent to prevent tax evasion and reflect "true" tax liability, but contains no discussion regarding what standard might determine "true" tax liability.[14] In 1935, the IRS issued transfer pricing that read: "[t]he purpose of [s]ection 45 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer."[15] This marks the birth of the arm's length standard. But notice, at inception, the arm's length standard served merely as a *means* to achieve taxpayer parity.

Theoretically, the arm's length standard's use of comparable transactions creates a clear legal requirement. For a typical transfer pricing transaction, the Treasury regulations produce a range of results; if the taxpayer can demonstrate its price falls within the permitted range, it can avoid an IRS transfer pricing adjustment.[16] Unfortunately, rapid globalization, the rise of multinational enterprises, and a growing market for intangibles have all but eliminated the "typical" transfer pricing transaction.[17] If the arm's length

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12. *See* Reg. § 1.482–1(b)(1) ("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.").

13. *See* Revenue Act of 1928, ch. 852, § 45, 45 Stat. 806 (1928).

14. *See, e.g.*, H.R. Rep. No. 2, 70th Cong., 1st Sess. 16–17 (1927); *accord* S. Rep. No. 960, 70th Cong., 1st Sess. 24 (1928); *see also* Reuven 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, 96 (1995) [hereinafter Avi-Yonah, *Rise and Fall of Arm's Length*].

15. Revenue Act of 1934, Art. 45-1(c) of Reg. 86 (1935) (cited in full by Essex Broadcasters, Inc. v. Commissioner, 2 T.C. 523, 531 (1943)); *see also* Avi-Yonah*, Rise and Fall of Arm's Length*, supra note 14, at 97.

16. Reg. § 1.482–1(b)(1).

17. *See generally* Reuven Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2 WORLD TAX J. 3, 3 (2010) [hereinafter Avi-Yonah, *Proposal for Reconciliation*]

> Such an approach might well have made sense 80 years ago, when the legislative language underlying today's arm's length

standard is to serve as the basis for a workable transfer pricing system, functional analysis designed to identify uncontrolled comparable transactions must be successful with sufficient regularity.[18] But reasonably comparable transactions are becoming more and more difficult to identify, and without comparable transactions, legal indeterminacy prevails:

> Using the term "failure" to describe any legal rule, much less a global legal regime, can tend toward hyperbole. Nevertheless, to the extent that [the arm's length standard] is clearly inadequate to the task it is implemented to fulfill–the allocation of the corporate tax base of MNEs—[the arm's length standard] is a failed doctrine. Central to this failure is the disconnect between the assumptions at the core of [the arm's length standard] about the nature of intra-firm transactions and the economic reality of those transactions. With the increasing pace of globalization, this disconnect between the assumptions of [the arm's length standard] and the reality of global commerce will only widen, and the use of [the arm's length standard] to allocate global income on a national basis less tenable.[19]

The IRS has attempted to bridge this disconnect between economic reality and the arm's length standard's inaccurate core assumptions by promulgating excruciatingly detailed regulations. The cost sharing regulation at issue in the *Xilinx* case represents one such attempt.

> standard for income tax purposes was first developed. At that time, although multinational groups existed, available transportation and communications technology did not permit close centralized management of geographically dispersed groups. Therefore, members of multinational groups functioned largely as independent entities, and benchmarking their incomes or transactions based on uncontrolled comparables probably made good sense.

Id. at 8.

18. *See* Avi-Yonah, *Proposal for Reconciliation*, *supra* note 17, at 12.

19. Glen Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem: Allocating the Tax Base of Multi-National Entities Based on Real Economic Indicators of Benefit and Burden*, 22 DUKE J. COMP. & INT'L L. 425, 436 (2012) [hereinafter Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem*].

B. Disparities between Transfer-Pricing Legal Fiction and Reality

To understand how this complex transfer pricing system evolved, one must recognize the significant disparities between the legal fiction of transfer pricing and economic reality. The predominant issue is that "comparable transactions" do not necessarily exist. When MNE intra-firm transactions make up more than 60 percent of global trade and most international business occurs between related entities,[20] what constitutes comparable? And, if a somewhat-comparable transaction can be established after adjustments, how many degrees of separation are acceptable?

This lack of comparable transactions highlights a fundamental problem with the arm's length standard: it is based on a legal fiction. At its core sits the economic fallacy that parties' relatedness is merely *incidental* to MNE intra-firm transactions, while in reality, the parties' relatedness is the MNE's raison d'être:

> The multinational's structure allows it to avoid (internalize) transaction costs, which increases efficiency in raising capital, advertising products, achieving economies of scale, and protecting valuable intangibles. Thus, if one applies a market rate of return separately to each of the components of the multinational, the result is less than the actual return of the organization as a whole. This residual, the result of the interaction among the constituent parts of the organization, cannot be assigned to any component. Any transfer pricing rule which arbitrarily assigns the residual to one part of the organization distorts economic reality. [. . .] The implications of this [. . .] are profound. If comparables can be found, that fact indicates the multinational does not derive a large residual return from its structure because otherwise it could have driven its competitors out of the market. Thus, in these cases it would be possible to use functional analysis without having a comparable. On the other hand, where comparables cannot be found, such as in the majority of complex transfer pricing cases, that fact indicates a large residual is likely, and this residual advantage of the multinational has driven competitors out of the market. Thus, precisely in those situations arising in the majority of transfer pricing cases, where there are no comparables and therefore functional analysis is required, it will be impossible to find the "right" transfer price. Even if one performs a functional analysis

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20. Matthew Saltmarsh, *Tax Enforcers Intensify Focus on Multinationals*, N.Y. TIMES, Jan. 4, 2010, at B3.

> based on the market returns of all the components of the multinational, a large residual will remain to be split arbitrarily among the parties. The IRS will seek to allocate all the residual to one party, the taxpayer to another, and it is likely some of it will not be taxed by any jurisdiction.[21]

In other words, integrated firms arise precisely because of the economic advantage relative to comparable uncontrolled transactions. This economic advantage is also the reason the arm's length standard fails to create taxpayer parity; by treating an integrated firm as unrelated, its residual profit goes untaxed–thereby lowering its effective tax rate.

But it is important to point out the arm's length standard is not a failure simply because it is based on a legal fiction. The arm's length standard is a failure because it is based on a legal fiction that complicates and obscures instead of simplifying.[22] U.S. tax law contains some wonderful legal fictions that streamline administrability and promote predictability, like the Modified Accelerated Cost Recovery System used to calculate depreciation deductions under sections 167 and 168. But to accomplish the goal of increased simplicity and administrability, a phantom accounting system must be highly standardized with subjectivity only at the margins. Thus, the revisionist arm's length standard is an administrative failure.[23]

In addition to being an enormous administrative burden, the arm's length standard results in pervasive uncertainty. Absent clear rules, neither the taxpayer nor the IRS can know in advance the likely revenue outcome in a transfer pricing case.[24] Limited, confusing, and contradictory case law further intensifies this quagmire–as the *Xilinx* cost sharing agreement illustrates.[25]

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21. Avi-Yonah, *Rise and Fall of Arm's Length, supra* note 14, at 149.

22. *See* Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem*, *supra* note 19, at 440.

23. *Id.*

24. *See* Avi-Yonah, *Rise and Fall of Arm's Length, supra* note 14, at 151.

25. *See generally* Seminole Flavor Co. v. Commissioner, 4 T.C. 1215 (1945) (relying on "fair and reasonable" test); Frank v. Int'l Canadian Corp., 308 F.2d 520 (9th Cir. 1962) (questioning whether arm's length standard should be applied in all cases—held that while ALS was not "improper," it was not the "sole criterion"); Oil Base, Inc. v. Commissioner, 23 T.C.M. (CCH) 1838, T.C.M. (P-H) ¶ 64,298 (1964) (ruling significantly narrowed "sole criterion" application to situations where there is no evidence of arm's length price and because of the "complexity of the circumstances . . . it would have been difficult for the court to hypothesize an arm's length transaction"); Eli Lilly & Co. v. Commissioner, 856 F.2d 855 (7th Cir. 1988) ([taxpayer] citing *Frank* as justification for using "fair and reasonable price" in the

C. *Cost Sharing Agreements*

A cost sharing agreement (CSA) consists of two or more controlled parties sharing research and development costs and risks in exchange for a specified interest in the final product.[26] As the IRS explained in 1988, Congress envisioned "the use of bona fide research and development cost sharing arrangements as an appropriate method of attributing the ownership of intangibles *ab initio* to the user of the intangible, thus avoiding section 482 transfer pricing issues related to the licensing or other transfer of intangibles."[27]

Under the 1995 Final Regulations in effect during the years at issue in *Xilinx*, a CSA was an agreement in which related parties agreed to share intangible development costs in proportion to each participant's expected benefit.[28] To qualify as a CSA, cost calculations were required to include "all costs" related to the intangible development.[29] Notably, the regulations did not explicitly address treatment of employee stock options in CSA cost

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absence of comparables—court held that arm's length standard applied, but then confusingly ruled in favor of Commissioner's arbitrary reassignment of profits as "reasonable" despite lack of arm's length comparables); Lufkin Foundry & Mach. Co. v. Commissioner, 468 F.2d 805, 808 (5th Cir. 1972) (holding that comparisons of related party results alone cannot be the basis of the arm's length price); Ross Glove Co. v. Commissioner, 60 T.C. 569 (1973); *see also* Avi-Yonah, *Rise and Fall of Arm's Length, supra* note 14, at 111.

> The courts came a long way. A mere decade before *Lufkin*, the *Frank* court had declared that, contrary to the regulations, the ALS was only one of many possible criteria under section 482. It then became the sole criterion, set by "unquestioned" regulations, and any attempt to establish transfer prices without referring to comparables was invalid. Little guidance, however, was given on what to do in the absence of comparables; and in light of his failed attempts in *PPG Industries* and *Ross Gloves* to use evidence that was not based on the ALS, the Commissioner may well have wondered whether his victory in *Lufkin* could turn out to be a pyrrhic one.

Id.

26. *See generally* CYM LOWELL & PETER BRIGER, U.S. INTERNATIONAL TRANSFER PRICING ¶ 5.08, Westlaw 257470 2015 (providing definition and examples of cost sharing agreements).

27. Notice 88–123, 1988–2 C.B. 458.

28. *See* Reg. § 1.482–7(a)(1) (1995).

29. *See* Temp. & Prop. Reg. § 1.482-7, 60 Fed. Reg. 65553 (Feb. 26, 1996); *see also* Levey & Arthur, *Cost Sharing Developments in the U.S.*, *supra* note 9, at 22.

calculations until the IRS issued proposed regulations in 2002.[30] In 2005, the IRS promulgated lengthy proposed regulations providing detailed criteria for determining each element in the CSA.[31] Temporary regulations followed in January 2009, offering further guidance on applying the arm's length standard to cost sharing agreements and buy-in payments.[32] The current rules for determining the arm's length price for related-party CSAs, found in Regulation section 1.482–7, are conceptually very similar to the 1995 regulations.[33] Yet, as in *Xilinx*, the current regulations' unequivocal inclusion of employee stock options in CSA cost calculations is not necessarily compatible with the arm's length standard.

III. THE *XILINX* SAGA

Xilinx, Inc., a domestic corporation, specialized in programmable logic devices and software systems. In 1995, Xilinx and its Irish affiliate, Xilinx-Ireland, entered into a CSA to share research and development costs proportionate to anticipated benefits.[34] The shared costs included direct costs

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30. *See* Prop. Reg. § 1.482–7, 67 Fed. Reg. 48997 (Jul. 29, 2002).

31. *See* Prop. Reg. § 1.482–7, 70 Fed. Reg. 51116 (Aug. 29, 2005).

32. *See* Temp. Reg. §§ 1.482–1T(b)(2)(i), (iii), 1.482–4T(g), 1.482–7T(b)(5), 1.482–9T(m)(3); T.D. 9441, 74 Fed. Reg. 340 (Jan. 5, 2009); *see also* Baker & McKenzie North America Transfer Pricing Group, *Cost Sharing Arrangements Are Less Attractive Under New Regulations*, 20 J. INT'L. TAX 24, 24 (2009).

33. Reg. § 1.482–7(d)(iii).

34. *See generally* NICK RABY, INTERNATIONAL TRANSFER PRICING 2013/2014 83, 92 (2014), http://www.pwc.com/gx/en/international-transfer-pricing/assets/itp-2013-final.pdf.

> A valid cost-sharing arrangement between members of a group of companies involves a mutual written agreement, signed in advance of the commencement of the research in question, to share the costs and the risks of R&D to be undertaken under mutual direction and for mutual benefit. Each participant bears an agreed share of the costs and risks and is entitled, in return, to an appropriate share of any resulting future benefits. Cost-sharing arrangements of this nature are not unknown between companies that are not related, and in many respects resemble joint venture activities or partnerships. As a result, there is a prima facie indication that they are likely to be acceptable in principle to the majority of tax authorities.

Id. at 92.

(*e.g.*, salaries, payroll, bonuses, benefits), indirect costs (*e.g.*, administrative, legal, accounting, insurance), and costs of acquired intellectual property rights.[35] Though the agreement adhered to the 1995 regulations' "cost pool" requirements, it did not include costs related to employee stock option (ESO) compensation. In 1996, the companies finalized stock option agreements permitting Xilinx-Ireland employees to obtain Xilinx, Inc. stock options. For tax years 1997 through 1999, Xilinx deducted $177 million in business expenses related to employee exercises of stock options. The company also claimed related research and development credits totaling $84 million.[36]

The relevant Treasury regulation required taxpayers to include all expenses related to intangibles' development in their cost sharing pool.[37] However, in computing its taxable income under section 83(h), Xilinx deducted an amount equal to the spread, on the exercise date, between the stock option's exercise price and the stock's fair market value.[38] Subsequently, the IRS recomputed Xilinx's income—including the difference between the ESO's fair market value when the options were exercised over the exercise price in the cost pool—and issued a deficiency notice.[39]

The issue for the court in *Xilinx* was two-fold: whether stock options involve a "cost" at all and, if so, whether parties negotiating at arm's length would include that stock option "cost" in a cost sharing agreement.

The IRS maintained: (i) the stock options were costs related to intangible development; and (ii) stock options exercised in 1997 and 1998 should be included in the CSA under Regulation section 1.482–7(d)(1).[40] Xilinx, on the other hand, asserted that: (i) because there was no cash outlay, no "cost" was incurred; and (ii) even if the stock options were costs, Regulation section 1.482–7(d)(1) was inconsistent with the arm's length standard because unrelated parties would not agree to share these costs.[41]

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35. *Xilinx I*, 125 T.C. 37, 40 (2005); *see, e.g.*, Levey & Arthur, *Cost Sharing Developments in the U.S.*, *supra* note 9, at 24.

36. *See* Brief for Respondent at 7, Xilinx Inc. & Subsidiaries v. Commissioner, 125 T.C. 37 (2005) (No. 4142-01), 2002 WL 34234096 at 7; *see generally Ninth Circuit Reverses Itself in* Xilinx, 16 J. ACCOUNTANCY 86 (2010) (explaining details of ESO arrangement and price spread calculations).

37. Reg. § 1.482–7(d)(1).

38. *See generally* Charles Cope & Thomas Zollo, *The Ninth Circuit Affirms the Tax Court's Decision in* Xilinx*, But Some Issues Remain Unresolved*, 39 TAX MGMT. INT'L J. 344, 347 (2010).

39. *See Xilinx I*, 125 T.C. at 47.

40. *See* Brief for Respondent at 20–27, Xilinx Inc. & Subsidiaries v. Commissioner, 125 T.C. 37 (2005) (No. 4142-01), 2002 WL 34234096 at 27.

41. *Xilinx I*, 125 T.C. at 59.

A. Xilinx I: *Tax Court, 2005*

The Tax Court held the arm's length standard does apply to cost sharing agreements (*Xilinx I*).[42] The court did not rule on whether ESOs were costs because it found unrelated parties would not share stock options even if they were a "cost."

The IRS did not attempt to argue the ESO allocation was arm's length, declaring instead that applying the express terms of Regulation section 1.482–7 produced arm's length allocations.[43] The Tax Court ruled in favor of the taxpayer writing: "Simply put, the regulations applicable to the years in issue did not authorize [the IRS] to require taxpayers to share the spread or the grant date value relating to ESOs. Petitioners are merely required to be compliant, not prescient. Accordingly, we hold that [Commissioner's] allocations are arbitrary and capricious; petitioners' allocations meet the arm's length standard mandated by section 1.482–1 . . . ."[44]

B. Xilinx II: *Ninth Circuit Reversal, 2009*

On appeal, the Ninth Circuit initially reversed and remanded to the Tax Court with the majority finding that—although the regulations conflicted—ESOs were costs and must therefore be included in cost sharing agreement calculations even if unrelated parties would not share such costs (*Xilinx II*).[45]

Relying on an "elementary tenet of statutory construction," the majority opinion read: "In sum, we conclude the arm's length regulation, [section] 1.482–1(b)(1), and the all costs regulation, [section] 1.482–7(d)(1), cannot be harmonized. Accordingly, we hold [section] 1.482–7(d)(1), being the more specific of the two, controls."[46] Judge Noonan's dissent urged the court to rely instead on the regulations' dominant purpose to resolve the conflict:

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42. *Xilinx I*, 125 T.C. 37.

43. *Xilinx I*, 125 T.C. at 54–56; *see also* Brief for the Appellee, Xilinx Inc. & Subsidiaries v. Commissioner, 125 T.C. 37 (2005) (Nos. 06-74246, 06-74269), 2007 WL 1241433.

44. *Xilinx I*, 125 TC at 63 (2005).

45. *Xilinx II*, 567 F.3d 482 (9th Cir. 2009).

46. Xilinx, Inc. v. Commissioner, 567 F.3d 482, 492–93 (9th Cir. 2009) *opinion withdrawn*, 592 F.3d 1017 (9th Cir. 2010) *and superseded*, 598 F.3d 1191 (9th Cir. 2010) *recommendation regarding acq.*, IRS *action on dec.*, 2010-03 (Jul. 28, 2010) and *acq. in result*, IRS Announcement Relating to: Xilinx, Inc., 2010-33 I.R.B. 240 (Aug. 16, 2010).

> The Commissioner of Internal Revenue has issued regulations that are irreconcilable. These are the regulations relevant to this case. We have three alternatives:
>
> 1. Hold that when the Commissioner talks out of both sides of his mouth, his speech is unintelligible and his regulations are unenforceable.
> 2. Apply a rule of thumb: the specific controls the general.
> 3. Resolve the conflict based on the dominant purpose of the regulations, aided by the basic rule that ambiguous documents are to be interpreted against the drafter and further enlightened by the way the Treasury has proceeded in drafting tax treaties relevant to American parents and their foreign subsidiaries.
>
> The majority has chosen the second alternative. It is a simple solution. It is plausible. But it is wrong. It converts a canon of construction into something like a statute. It ignores the international context and the Treasury's own practice[, and] I chose the third alternative.[47]

C. Xilinx III: *Ninth Circuit Reconsideration, 2010*

The Ninth Circuit's original decision prompted not only a petition for rehearing by Xilinx but also drew criticism from treaty partners, trade organizations, and corporations.[48] Consequently, on January 13, 2010, the

47. *Xilinx II*, 567 F.3d at 497.

48. *See* Petition for Panel Rehearing & Petition for Rehearing En Banc (from May 27, 2009 opinion), *Xilinx II*, (9th Cir. 2009) (06-74269); *see also Xilinx III*, 598 F.3d at 1198 n.2 ("Apparently Xilinx's understanding was widely shared in the business community and tax profession"; referring to amici briefs filed by: Cisco Systems Inc., Altera Corp., Former U.S. Treasury and IRS Officials, PricewaterhouseCoopers, Deloitte Tax LLP, Apple Inc., KPMG LLP, Abbott Laboratories, Adobe Systems Inc., Akzo Nobel Inc., Boeing, Caterpillar Inc., Chevron Corp., Dow Chemical Co., E.I. Du Pont De Nemours & Co., Electronic Arts Inc., Eli Lilly & Co., EMC Corp., Google Inc., Johnson & Johnson, JPMorgan Chase & Co., Juniper Networks Inc., Merck & Co., Microsoft Corp., Netapp Inc., Nike Inc., PepsiCo

Court issued the following one-sentence order: “The opinion and dissent filed on May 27, 2009 are hereby WITHDRAWN.”[49]

On March 22, 2010, the Ninth Circuit affirmed the Tax Court’s holding (*Xilinx III*).[50] Judge Noonan’s 2009 dissent was recast as the majority opinion, concluding: “[t]he Tax Court found related companies are not required to share such costs and ruled that the Commissioner of Internal Revenue’s attempt to allocate such costs was arbitrary and capricious. We affirm.”[51]

As in *Xilinx II*, the court unanimously concluded Regulation sections 1.482–1 and 1.482–7 conflicted. But rather than resolving this conflict by having the specific provision control the general, the court resolved the ambiguity by having the regulation’s dominant purpose prevail—ensuring parity between taxpayers.[52] Since the statute’s purpose is to create parity between taxpayers in controlled transactions and taxpayers in uncontrolled transactions, the court held the regulations should not be construed to negate that purpose.[53]

Inc., Pfizer Inc., Proctor & Gamble, Qualcomm Inc., Symantec Corp., United Parcel Service, United Technologies Corp., Verizon Communications, Vodafone Americas Inc., Walt Disney, Wells Fargo & Co., Xerox Corp., and the Chamber of Commerce for the United States of America.); *accord* IRS *action on dec.*, 2010-03 (July 28, 2010).

> Xilinx petitioned for rehearing or rehearing en banc, on the basis of the primacy of the arm’s length standard, and was supported by numerous amici briefs that attested to the importance of the arm’s length standard, but did not universally reject the outcome of the Ninth Circuit’s initial opinion. In its response, the Service supported the outcome of the original Ninth Circuit opinion, but did not agree with Taxpayer’s or the Ninth Circuit’s interpretation of the arm’s length standard. The Service did agree however that the arm’s length standard applied to the case.

Id.

49. Xilinx, Inc. v. Commissioner, 592 F.3d 1017, 1018 (9th Cir. 2010) (withdrawing 2009 opinion); *see also Ninth Circuit Pulls* Xilinx *Decision Construing Prior Regs to Require Cost-sharing of Stock Options*, 56 FED. TAXES WKLY. ALERT 3 (Jan. 21, 2010).

50. Xilinx, Inc. and Subsidiaries v. Commissioner, 125 T.C. 37 (2005), *rev’d*, 567 F.3d 482 (9th Cir. 2009), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010), *aff’d*, 593 F.3d 1191 (9th Cir. 2010).

51. *Xilinx III*, 598 F.3d at 1192.

52. *See id.* at 1196.

53. *See id.*

The IRS issued an Action On Decision in response to the Ninth Circuit's ruling, rejecting the court's reasoning but acquiescing in the result. The Action On Decision posits that—contrary to the Ninth Circuit's view—the provisions under Regulation sections 1.482–1(b)(1) and 1.482–7 "are mutually consistent and the sharing of all costs, including ESO costs, under a CSA conforms to the arm's length standard."[54] The Action On Decision also declared the revised regulations made the Ninth Circuit's "erroneous interpretation" irrelevant.[55]

IV. WHERE DO WE GO FROM HERE?

In a footnote, Judge Fisher's concurring opinion mentions that "[i]t is an open question whether these flaws have been addressed in the new regulations Treasury issued after the tax years at issue in this case."[56] The revised regulations explicitly state ESOs are costs that must be shared and the "all costs" requirement *is* an arm's length result.[57] Because no cost sharing cases have been decided since *Xilinx*, at least three potential answers exist to the question of what would the result be under subsequently issued regulations. (1) The IRS interpretation is correct–the regulations are both internally consistent and within the scope of the arm's length standard; (2) Judge Noonan's interpretation is correct–the regulations are (still) internally

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54. IRS Action on Decision, 2010-03 (July 28, 2010); *see also* William E. Massey, *IRS Rejects 9th Circuit's Reasoning in* Xilinx, *Acquiesces in Result*, 21 J. INT'L TAX'N 7, 8 (2010).

55. *See* IRS Action on Decision, 2010-03 (July 28, 2010).

> The significance of the Ninth Circuit's erroneous interpretation is mooted, however, by amendments to the regulations in 2003 by T.D. 9088. Those amendments make clear that a CSA produces an arm's length result within the meaning of Treas. Reg. [section] 1.482–1(b)(1) if, and only if, each controlled taxpayer bears its RAB share of all IDCs, including ESO and other stock-based compensation costs, and that Treas. Reg. [section] 1.482–7 provides the only method to be used to evaluate whether a CSA produces results consistent with an arm's length result. In light of this clarification, the Service will apply the result of the Ninth Circuit's decision to ESOs granted in taxable years governed by the regulations in effect prior to the 2003 amendments.

Id.

56. *See Xilinx III*, 598 F.3d at 1198 n.4; *e.g.*, Remy Farag, *Ninth Circuit Affirms Tax Court in* Xilinx *on Stock Options and Cost-Sharing*, 21 J. INT'L TAX'N 5, 6 (2010).

57. *See* Reg. § 1.482–7(a)(4).

inconsistent, which means the arm's length standard controls, and *Xilinx* thereby invalidates regulations conflicting with the arm's length standard; or (3) both the IRS and the Ninth Circuit are incorrect–the regulations are internally inconsistent as well as arbitrary and capricious, but allowing the arm's length standard to nullify irreconcilable regulations fails to solve the problem.

A. *Scenario 1: IRS Interpretation is Correct*

The IRS maintains the Treasury can be read as internally consistent and within the scope of the arm's length standard.[58] Unlike the at issue in *Xilinx*, the most recently promulgated cost sharing provisions specifically include ESOs in the list of "all costs" that must be shared in a cost sharing arrangement.[59] Therefore, some experts believe future courts would give the IRS *Chevron* Deference because the "all costs" provision is a reasonable interpretation of the statute.[60] Under *Chevron U.S.A., Inc. v. Natural Resources Defense Counsel*,[61] allocations provided by regulations under

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58. *See* IRS Action on Decision, 2010-03 (July 28, 2010).
59. See I.R.C. § 1.482–7(d)(iii) providing:

> For purposes of this [s]ection, IDCs mean all costs, in cash or in kind (including stock-based compensation, as described in paragraph (d)(3) of this [s]ection), but excluding acquisition costs for land or depreciable property, in the ordinary course of business after the formation of a CSA that, based on analysis of the facts and circumstances, are directly identified with, or are reasonably allocable to, the IDA. Thus, IDCs include costs incurred in attempting to develop reasonably anticipated cost shared intangibles regardless of whether such costs ultimately lead to development of those intangibles, other intangibles developed unexpectedly, or no intangibles. IDCs shall also include the arm's length rental charge for the use of any land or depreciable tangible property . . . directly identified with, or reasonably allocable to, the IDA. Reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not be conclusive regarding inclusion of costs in IDCs.

60. *E.g.*, Dix, *From General to Specific*, *supra* note 6, at 218; *see also* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843 (1984).
61. *Chevron*, 467 U.S. at 843.

section 482 would be sustained unless abuse of discretion is present.[62] For a taxpayer to win under *Chevron* Deference, IRS actions must be arbitrary and capricious.[63]

Importantly, the Ninth Circuit did not rule against the IRS simply because the regulations were written ambiguously, but because the court found they were internally inconsistent–resulting in unfair and unpredictable results.[64] Thus, increasing the specificity of still-internally-inconsistent regulations does not produce a more predictable outcome for taxpayers. To illustrate, Regulation section 1.482–1(b) states: "the standard to be applied in *every case* is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer."[65] Contrast this mandatory application of the arm's length standard in *every case* with Regulation section 1.482–7, which requires related parties in a cost sharing agreement to allocate "all costs" of developing the intangible.[66]

Interestingly, the Commissioner did not dispute the Tax Court's factual finding that unrelated parties would not share ESOs as a cost. Instead, the Commissioner asserted ESOs are a cost that must be shared under

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62. *See, e.g.*, Sundstrand Corp. & Subsidiaries v. Commissioner, 96 T.C. 226 (1991).

63. *See id.*; *see also*, *e.g.*, Bausch & Lomb Inc. v. Commissioner, 933 F.2d 1084 (2d Cir. 1991); *accord* G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987).

64. *See Xilinx III*, 598 F.3d at 1196.

> The language is unequivocal: this arm's length standard is to be applied "in every case." In the context of cost sharing agreements, this rule would require controlled parties to share only those costs uncontrolled parties would share. By implication, costs that uncontrolled parties would not share need not be shared. In contrast, [section] 1.482–7A(d)(1) specifies that controlled parties in a cost sharing agreement must share *all* "costs . . . related to the intangible development area," and that phrase is explicitly defined to include virtually all expenses not included in the cost of goods. The plain language does not permit any exceptions, even for costs that unrelated parties would not share. Each provision's plain language mandates a different result. Accordingly, we conclude that when related to each other, the two provisions establish an ambiguous standard for determining which costs must be shared between controlled parties in cost sharing agreements specifically related to intangible product development.

Id.

65. Reg. § 1.482–1(b)(1) (emphasis added).

66. *See* Reg. § 1.482–7(d)(1).

Regulation section 1.482–7, even if unrelated parties would not share them.[67] Therefore, explicitly requiring related parties to share a cost unrelated parties would not share is inconsistent with the arm's length standard. Despite increased specificity to eliminate ambiguity, the conflict remains unchanged under the current regulations.

The current regulations go beyond including ESOs in the revised definition of "all costs," adding that a cost sharing agreement is consistent with the arm's length standard if—*and only if*—the "all costs" requirement is satisfied.[68] Thus, the present IRS stance appears more arbitrary and capricious than their losing position in *Xilinx III*. The IRS has the authority to create safe harbors by deeming transactions be treated as arm's length if the taxpayer satisfies certain elective conditions, effectively expanding the realm of protected transactions in exchange for voluntary cooperation. A safe harbor's purpose is to increase taxpayer and IRS certainty, thereby reducing transaction costs and risks. In contrast, including the clause "if and only if" indicates compliance with the "all costs" language is mandatory. Thus, the IRS has created the opposite of a safe harbor–departing from the arm's length standard to promulgate an additional, and conflicting, rule. This effectively erodes the realm of protected transactions, while furthering the Potemkin village of regulatory consistency. In sum, the IRS ought to create exceptions, like safe harbors, when it benefits taxpayers and the government, decreases transaction costs, and improves taxpayer certainly. This logic does not, however, suggest the IRS ought to infringe on otherwise clearly protected arm's length transactions, as the IRS's "if and only if" language does in this instance.

Merely stating an allocation is arm's length does not make it so. Thus, adding the "if and only if" provision amplifies–rather than resolves–the inconsistency between the regulations.[69] In light of the IRS's absolute refusal to recognize the irreconcilable inconsistencies present in the regulations or, alternatively, to abandon the arm's length standard when appropriate, it seems unlikely a lower court would disagree with the Tax Court and Ninth Circuit in the foreseeable future.

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67. *See Xilinx III*, 598 F.3d at 1194; *see also* Rufus Rhoades, *The Even More Curious Case of* Xilinx, Inc. v. Commissioner, LEXISNEXIS (2010), https://advance.lexis.com/api/permalink/7c1ee3fb-4bc6-4e27-ace8-8a0ff7475fed/?context=1000516.

68. Reg. § 1.482–7(a)(4) (stating that a cost sharing agreement "produces results that are consistent with an arm's length result within the meaning of [section] 1.482–1(b)(1) if, and only if [the 'all costs' provisions of section 1.482–7 are satisfied]").

69. *See* Levey & Arthur, *Cost Sharing Developments in the U.S.*, *supra* note 9, at 27.

Moreover, the IRS position is problematic because it discourages compliance and incentivizes tax avoidance. The section 482 transfer pricing regulations are unworkably complex. In fact, observers have described the regulations as "a cumbersome creation of stupefying complexity" with "rules that lack coherence and often work at cross purposes."[70] The desired outcome of these increasingly complex rules is, obviously, to prevent tax avoidance and arbitrage yet this complexity "tends to create loopholes that then become ripe for exploitation."[71]

The United States has always taken pride in its innovativeness, but not all innovation leads to higher productivity. In the right environment, figuring out how to avoid corporate taxes can increase profits far more than making a better product.[72] The IRS interpretation of section 482 has created that ideal environment. Instead of rewarding corporations with a proclivity for regulatory arbitrage, U.S. tax policy should instead strive to encourage profit growth through legitimate innovation.

B. Scenario 2: Ninth Circuit Interpretation is Correct

While more compelling than the IRS's position, the Ninth Circuit's solution also leaves much to be desired. If the Ninth Circuit is correct: (i) regulations that conflict with the arm's length standard are invalid under the current regulations; (ii) taxpayers have inadequate notice of how the regulations will affect them; and (iii) the IRS is precluded from treating the arm's length standard as a legal principle rather than a legal rule.

Aspects of the court's ruling are certainly appealing. Primarily, the decision upholds what the IRS has always guaranteed under section 482—if a transaction is consistent with the arm's length standard, the taxpayer is impervious to adjustments.[73] Put another way, the court's ruling aligns with the belief that, once an arm's length price has been corroborated, a taxpayer can decisively state it has not evaded taxes. And taxpayers should reasonably

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70. *See* Willard Taylor, *Testimony before the President's Advisory Panel on Federal Tax Reform*, TAX NOTES (April 4, 2005) Doc 2005-6654; *see also* Avi-Yonah, *Proposal for Reconciliation*, *supra* note 17, at 10.

71. Alen Mattich, *On Apple, Fiat and Corporate Tax Arbitrage*, WALL ST. J. MONEYBEAT (Sept. 3, 2014, 6:24 AM), http://blogs.wsj.com/moneybeat/2014/09/30/on-apple-fiat-and-corporate-tax-arbitrage/; *see generally* Merle Erickson et al., *How Prevalent Is Tax Arbitrage? Evidence from the Market for Municipal Bonds*, NAT. BUR. ECON. RES. (2002), http://www.nber.org/papers/w9105.pdf (discussing extent MNEs engage in tax arbitrage).

72. *See* Joseph Stiglitz, *The Roaring Nineties*, ATLANTIC MONTHLY, Oct. 2002, http://www.theatlantic.com/past/docs/issues/2002/10/stiglitz.htm.

73. *See* Santiago E. Fontiveros, *Xilinx—Transfer Pricing Cost Sharing and the Nuances of Legal Interpretation*, 21 J. INT'L TAX 36, 43 (2010).

be allowed to rely on the arm's length standard as the "clear reflection of income" touchstone articulated by the IRS for decades. The court's decision also incentivizes the IRS to write coherent and internally consistent rules, preventing legal indeterminacy.

At first glance, the court's opinion appears to be fair to the taxpayer because all other departures from the arm's length standard in the regulations occur in the context of safe harbors. Therefore, a regulation requiring a demonstrably non-arm's length result would not be invalid merely because the result would be non-arm's length, it must also harm—rather than benefit—the taxpayer. Put another way, a regulation may depart from the arm's length standard only if: (1) the departure benefits the taxpayer; or (2) the regulation unmistakably states its intent to depart from the arm's length standard.[74] Because the current regulations do not satisfy either condition, they fail to provide taxpayers with clear, fair notice of how the regulations will affect them.[75]

Despite the outcome's perceived fairness, however, the court's ruling may have been wrong for other policy reasons. If, as the Ninth Circuit held in *Xilinx II*, the general controls the specific—but determining when the general and specific are irreconcilable requires a court—taxpayers have no certainty.[76]

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74. *See id.* at 40.

75. See *Xilinx III*, 598 F.3d at 1198 (Fisher, J., concurring), stating that:

> Indeed, I am troubled by the complex, theoretical nature of many of the Commissioner's arguments trying to reconcile the two Regulations. Not only does this make it difficult for the court to navigate the regulatory framework, it shows that taxpayers have not been given clear, fair notice of how the regulations will affect them.

76. *Cf.* Yehonatan Givati, *Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings*, 29 VA. TAX REV. 137, 173 (2009). Givati explains why IRS Advance Pricing Agreements fail to mitigate this taxpayer uncertainty:

> The waiting period for completing an advance pricing agreement is very long—the median waiting period in 2006 was 28 months. Moreover, requesting an advance pricing agreement is costly. The application fee for an advance pricing agreement is $50,000, and in addition significant payments have to be made to lawyers and economists. . . . Notwithstanding the aforementioned explanations, it seems that the infrequent use of advance pricing agreements is also explained by the same strategic considerations that explain the infrequent use of advance tax rulings. . . . Given the fact-intensive nature of transfer pricing audits, they are expensive to

This problem may be best understood within the framework of rules and principles:

> The difference between legal principles and legal rules is a logical distinction. Both sets of standards point to particular decisions about legal obligation in particular circumstances, but they differ in the character of the direction they give. Rules are applicable in an all-or-nothing fashion. If the facts a rule stipulates are given, then either the rule is valid, in which case the answer it supplies must be accepted, or it is not, in which case it contributes nothing to the decision . . . . The rule might have exceptions, but if it does then it is inaccurate and incomplete to state the rule so simply, without enumerating the exceptions. In theory, at least, the exceptions could all be listed, and the more of them that are, the more complete is the statement of the rule. But this is not the way [principles] operate. Even those which look most like rules do not set out legal consequences that follow automatically when the conditions provided are met.[77]

Thus, the Ninth Circuit's holding effectively served to convert a long-standing legal *principle* into a legal *rule*.

If the arm's length standard is treated as a rule, then the IRS's authority under the current regulations extends only to transactions with an arm's length comparable. But imagine a situation in which an arm's length comparable does not exist, like the transfer of unique intellectual property or

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> conduct. Therefore, the probability of the Service inspecting the taxpayer's transfer pricing method is relatively low, and by requesting an advance pricing agreement the taxpayer guarantees that his transfer pricing method will be inspected. . . . since in order to obtain an agreement they need to disclose details of their business operations, thus "red flagging" ambiguous tax issues to be considered by the Service. These tax issues may remain undetected in a regular audit. Furthermore, applying for an advance pricing agreement means that the taxpayer's transfer pricing method will be examined by the APA office, with expert agents who are less likely to make mistakes than regular auditors in the Service's district offices.

Id. at 173–74.

77. Ronald Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14, 25 (1968) [hereinafter Dworkin, *The Model of Rules*].

royalties paid for corporate goodwill and branding.[78] Permitting a non-arm's length outcome would be forbidden by the rule, and thus allowed only if the arm's length standard is abandoned (as we saw in *Xilinx II*) or modified. If we were dealing not with a rule but with a *principle*, that transfer prices ought to adhere to the arm's length standard when a comparable exists, then transfer prices without comparable transactions could be adjusted using another formula without altering the law.[79] This reasoning suggests principles may conflict with one another but rules may not. If two rules conflict, one cannot be a valid rule. Stated differently: by transforming the arm's length standard into a rule, the Ninth Circuit precludes the IRS from using the arm's length standard as a guiding principle when applicable, but explicitly carving out a formulary exception when no comparables exist. Likewise, when treated as a rule, the arm's length standard conflicting with another rule inevitably results in legal uncertainty, if not invalidation.[80]

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78. *E.g.*, European Commision, *State Aid SA.38374 (2014/C) (ex 2014/NN) (ex 2014/CP)–Netherlands Alleged Aid to Starbucks*, 2014 O.J. (C 460) 36 (Nov. 6, 2014), http://ec.europa.eu/competition/state_aid/cases/253201/253201_1596706_60_2.pdf (concluding royalty fees paid by Starbucks's Dutch manufacturing business may have been overestimated to reduce the company's tax burden; and the European Commission noted: the royalty "does not reflect the value of the IP" because it "fluctuates from year to year and is not in line with sales"); *accord* Tom Fairless, *Huge Profit Stokes Concerns Over Starbucks's Tax Practices in Europe*, WALL ST. J., Apr. 6, 2015, http://www.wsj.com/articles/starbuckss-tax-practices-draw-european-scrutiny-1428363189.

79. *See* Dworkin, *The Model of Rules*, *supra* note 77, at 29.

80. *See generally* John Braithwaite, *Rules and Principles: A Theory of Legal Certainty*, 27 AUSTL. J. LEGAL PHIL. 47 (2002). Professor Braithwaite argues that:

> [P]recise rules more consistently regulate simple phenomena than principles. However, as the regulated phenomena become more complex, principles deliver more consistency than rules. A central reason is that the iterative pursuit of precision in single rules increases the imprecision of a complex system of rules. By increasing the reliance we can place on a part of the law we reduce the reliability of the law as a whole. . . . When the type of action to be regulated is simple, stable (not changing unpredictably across time) and does not involve huge economic interests, rules regulate with greater certainty than principles. . . . With complex actions in changing environments where large economic interests are at stake principles are more likely to enable legal certainty than rules.

Moreover, if taxpayers are unable to locate a comparable arm's length transaction, does this make it certain unrelated parties would never enter into such an arrangement? At what point can a taxpayer rely on a lack of comparables? Logically, a taxpayer cannot prove nonexistence. This is problematic because section 482 places the burden of proof on the taxpayer to show a comparable transaction exists, or in this instance, does not exist. By permitting taxpayer reliance on inconclusive evidence, the Ninth Circuit's ruling incentivizes taxpayers to create intentionally convoluted arrangements to which no clear comparables exist and the arm's length standard cannot be applied:

> As the government cogently explained, Xilinx and its Irish subsidiary could not be compared to unrelated parties because they are related, which makes them jointly subject to fluctuations in the price of Xilinx stock in a way that would not apply in an arm's length situation. Therefore, comparables to sharing the cost of stock options can never be found, and the arm's length standard cannot be applied.[81]

Yet section 482 does not necessarily require transactions to be arm's length and the arm's length standard is not the only reasonable statutory interpretation–which simply authorizes adjustments to "clearly reflect income" and prevent "tax avoidance." As the IRS first articulated in 1935, the statute's purpose is ensuring taxpayer parity.[82] Consequently, the correct standard for deciding cost sharing cases is probably not the arm's length standard but instead the clear reflection of income standard taken directly from the statutory language.

C. *Scenario 3: Both the IRS and the Ninth Circuit are Incorrect*

Because the current regulations are irreconcilable and, therefore, arguably invalid, both the IRS and the Ninth Circuit interpretations are

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Id. at 47, 52–53; *see also* Genevieve Loutinsky, *Gladwellian Taxation: Deterring Tax Abuse Through General Anti-Avoidance Rules*, 12 HOUS. BUS. & TAX L. J. 82, 87 (2012).

81. Reuven Avi-Yonah, Xilinx *Revisited*, 126 TAX NOTES 1621, 1621 (March 23, 2010).

82. *See* Revenue Act of 1934, Art. 45-1(c) of Reg. 86 (1935) (cited in full by Essex Broadcasters, Inc. v. Commissioner, 2 T.C. 523, 531 (1943)); *accord* Reg. § 1.482–1 ("The purpose of [s]ection 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions. [s]ection 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer.").

incorrect. As long as the IRS refuses to clearly and explicitly diverge from the arm's length standard when necessary, courts are likely to rule the IRS lacks regulatory authority over transactions without an arm's length comparable.

When reviewing a regulation's validity, courts generally defer to the agency's interpretation of a statute.[83] The degree of deference typically depends on the type of regulation—whether, for example, the regulation is "legislative" or "interpretative."[84] That said, accurately identifying the type of rule promulgated by an agency can be difficult because substance and form are often inconsistent. Treasury's characterization of its own rules as interpretative is no exception.[85] The dominant test looks for any one of several factors considered to be conclusive evidence the rule carries the "force of law" or is "legally binding." These include: whether the rule is necessary to support an enforcement action; whether the statute is too ambiguous to be effectuated without legislative rules; whether the rule in question rescinds or amends another legislative rule;[86] and whether the agency published the rule in the Federal Register.[87] Thus, the section 482 regulations are clearly legislative in character.[88]

Although the question of judicial deference toward Treasury regulations remains unsettled and erratic, *United States v. Mead Corp.*[89] and

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83. *See* Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843 (1984).

84. *See generally* VANESSA K. BURROWS & TODD GARVEY, CONG. RESEARCH SER., R41546, A BRIEF OVERVIEW OF RULEMAKING AND JUDICIAL REVIEW (2011).

85. *See* I.R.M. 32.1.5.4.7.5(1) , http://www.irs.gov/irm, (providing that interpretative rules are not subject to the provisions of 5 U.S.C. sections 553(b), (c), and (d); although most IRS/Treasury regulations are interpretative and therefore not subject to these provisions of the APA, the IRS usually solicits public comments on all NPRMs.).

86. *See* Am. Mining Cong. v. Mine Safety & Health Admin., 995 F.2d 1106 (D.C. Cir. 1993) (listing factors relevant in determining whether a rule is legislative or interpretative).

87. *See* Health Ins. Ass'n of Am., Inc. v. Shalala, 23 F.3d 412, 423 (D.C. Cir. 1994) (providing non-dispositive evidence of agency intent; publication contradicts claim that rules were interpretative at time of issue); *see also* Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1766 (2007).

88. *But see* Estate of Gerson v. Commissioner, 127 T.C. 139 (2006) (Vasquez, J., dissenting) (expressing the opinion that regulations issued under general authority do not carry the force of law).

89. *See* United States v. Mead Corp., 533 U.S. 218 (2001).

Mayo Foundation for Medical Education & Research v. United States[90] can be read to warrant *Chevron* Deference for section 482 regulations because the IRS issued them through the exercise of congressionally delegated authority and they bind taxpayers with the force of law.[91] Moreover, under Auer-Seminole Rock Deference, courts grant the highest level of deference to an agency's interpretation of its own regulations, deferring unless the interpretation is "plainly erroneous or inconsistent with the regulation."[92] Because of this, the IRS has a relatively low bar to clear in order to be granted judicial deference under *Chevron*, *Mead*, *Mayo*, and *Auer-Seminole Rock*.

As both the origins and plain language of section 482 indicate, the law's ultimate purpose is to ensure taxpayer parity by allowing the Commissioner to reallocate income to prevent tax evasion and clearly reflect income. And as long as transfer pricing regulations are internally consistent and a "reasonable interpretation" of section 482, they will be judicially upheld. Therefore, the IRS ought to explicitly diverge from the arm's length standard in a way that taxes MNE's residual income more substantially and accurately than currently possible. Dogmatic adherence to the arm's length standard (a means) undermines taxpayer parity (the end).

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90. *See* Mayo Found. for Med. Educ. & Research v. United States, 562 U.S. 44 (2011).

91. *See generally* Kristin E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1538, 1544, 1602, 1608, 1618 (2006); *see also* David A. Brennen, *Treasury Regulations and Judicial Deference in the Post-*Chevron *Era*, 13 GA. ST. U. L. REV. 387, 428–30 (1997) (attempting to reconcile post-Chevron tax jurisprudence with Chevron). *But see* Niki R. Ford, Note, *Easy on the* Mayo *Please: Why Judicial Deference Should Not Be Extended to Regulations That Violate the Administrative Procedure Act*, 50 DUQ. L. REV. 799, 802 (2012) (urging Treasury regulations should not be given *Chevron* Deference if they were not properly enacted under APA procedure); *see also* Steve R. Johnson, *Preserving Fairness in Tax Administration in the* Mayo *Era*, 32 VA. TAX REV. 269, 285 (2012) (claiming "under *Mayo* and other recent case law, the *Chevron* two-step procedure appears to be receding as an independent rule of law. It is collapsing into a reasonableness inquiry pursuant to the APA statutory standard").

92. *See* Auer v. Robbins, 519 U.S. 452, 461 (1997); *accord* Bowles v. Seminole Rock & Sand Co., 325 U.S. 410, 413 (1945); *e.g.*, Kevin O. Leske, *Splits in the* Rock*: The Conflicting Interpretations of the* Seminole Rock *Deference Doctrine by the U.S. Courts of Appeals*, 66 ADMIN. L. REV. 787, 810 (2014); *also see generally* Stephen M. DeGenaro, Note, *Why Should We Care About an Agency's Special Insight?*, 89 NOTRE DAME L. REV. 909, 911 (2013).

D. *Are There Other "Reasonable Interpretations" of Section 482?*

The most widely accepted alternative to the arm's length standard–formulary apportionment—is also consistent with section 482's "clear reflection of income" language. The arm's length standard and formulary apportionment (sometimes referred to as a "unitary tax system") are typically presented as opposite and mutually exclusive. However, as Reuven Avi-Yonah urged in an article entitled *The Rise and Fall of Arm's Length*, "despite the common practice of contrasting the [arm's length standard] and the formulary methods of dealing with the transfer pricing problem, they are actually not dichotomous. Instead, they form the two extreme ends of a continuum."[93]

The starting point marks the primary difference between the arm's length standard and formulary apportionment. The arm's length standard begins by treating each entity in an affiliated group as a separate taxpayer dealing at arm's length. In contrast, formulary apportionment begins by treating the entire affiliated group as one unitary enterprise. The traditional arm's length standard does not have much in common with formulary apportionment. But, after years of IRS expansion, the (pre-*Xilinx*) arm's length definition actually looks quite similar to formulary apportionment.[94] To illustrate, picture a continuum with formulary apportionment at one end and the arm's length standard at the other; on this spectrum, the cost sharing provisions would be closer to formulary apportionment than to the arm's length standard.[95] This is because the cost sharing requirements start by considering the enterprise as a whole and work backward–supplementing arm's length prices with arbitrary apportionment of residual income. Because many cost sharing arrangements involve situations that would not occur between unrelated parties, requiring affiliated entities to split "all costs" is more akin to primitive formulary apportionment than an arm's length transaction.

1. *Multilateral Reform*

If the United States implemented formulary apportionment, it could occur in the context of multilateral reform or unilateral reform. Formulary apportionment is based on the economic reality of viewing an MNE as an

93. *See* Avi-Yonah, *Rise and Fall of Arm's Length, supra* note 14, at 90.
94. *Id.* at 134.
95. *See generally* Reuven Avi-Yonah, *Splitting the Unsplittable: Toward a Formulary Approach to Allocating Residuals Under Profit Split* (U. Mich. Pub. Law Research Paper Series, No. 378, 2013), http://ssrn.com/abstract=2369944.

integrated enterprise, rather than the legal fiction of related party independence, making multilateral reform preferable over unilateral reform.[96] Although ongoing OECD Base Erosion and Profit Shifting developments[97] suggest multilateral reform may be inevitable–or at least viable–the myriad existing tax treaties relying on the arm's length standard make it an intimidating undertaking.[98] And multilateral formulary apportionment faces an additional hurdle in the form of lobbying power because MNEs stand to lose billions of dollars per year globally if transfer pricing is reformed to tax their residual income.[99]

2. Unilateral Reform

Because multilateral reform cannot occur immediately, unilateral action could be taken in the interim. While U.S. treaty obligations impose some limitations on unilateral reform, formulary apportionment could be applied to residual income in the middle of the transfer pricing spectrum with probably relatively little protest from our trading partners:[100]

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96. *See* Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem*, *supra* note 19, at 442, ("It follows that in order to comprehensively avoid the possibility of double taxation, mutual agreement as to how that tax base is defined is necessary.").

97. OECD, ACTION PLAN, *supra* note 2.

98. *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income and on Capital Gains, U.S.-U.K. (2001 U.S.-U.K. Income Tax Convention), art. 9, July 24, 2001, Tax Treaties (CCH) ¶ 10,901.09, at 201,019; U.S. Model Income Tax Convention of Nov. 15, 2006 (2006 U.S. Model Income Tax Convention), art. 9, Tax Treaties (CCH) ¶ 209.09, at 10,559; Treasury Department Technical Explanation of the 2001 U.S.-U.K. Income Tax Convention, art. 9, Tax Treaties (CCH) ¶ 10,911, at 201,306 ("This Article incorporates in the Convention the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly Code section 482."); Treasury Department Technical Explanation of the 2006 U.S. Model Income Tax Convention, art. 9, Tax Treaties (CCH) ¶ 215, at 10,640 (stating the same).

99. *See generally* Joseph Stiglitz, *Reforming Taxation to Promote Growth and Equity*, ROOSEVELT INST. (2014), http://rooseveltinstitute.org/wp-content/uploads/2014/05/Stiglitz_Reforming_Taxation_White_Paper_ Roosevelt_Instiitute.pdf [hereinafter Stiglitz, *Reforming Taxation to Promote Growth and Equity*].

100. *Cf.* Avi-Yonah, *Proposal for Reconciliation*, *supra* note 17, at 12.

> [A] unilateral move by the United States to a formulary system is not likely to increase disputes with other high-tax countries; rather, it is likely to increase disagreements with low-tax countries that have sought actively to attract income and business

> The [U.S.] regulations assume that the residual [income] is the result of high profit intangibles and allocate it to where such intangibles were developed. However, this method is not helpful because (a) the OECD and the rest of the world rejects it, (b) it penalizes multinationals for conducting R&D in the U.S., and (c) it encourages multinationals to enter into cost-sharing agreements that artificially shift profits to low tax jurisdictions.[101]

If the U.S. approach is precluded, the glaring question is how to allocate the residual income. Because the OECD Guidelines are silent on this issue, it presents an opportunity: adopt a hybrid formulary-arm's length system to allocate the residual income.[102] This would promote taxpayer parity by predictably taxing each MNE's residual income, without infringing on our treaty partners' taxing rights or violating existing treaties.

Academics have proposed myriad potential indicators for formulary apportionment. Yet two particularly promising methods–at least for the purpose of unilateral action[103]—are: (1) applying formulary apportionment to a specific subset of intra-corporate transactions for which the arm's length standard is particularly ill suited[104] (limited formulary apportionment); and (2) adopting formulary apportionment specifically tailored to certain types of income[105] (flexible formulary apportionment).

> from the United States. It is not clear that avoidance of these kinds of tax disputes constitutes a valid reason to delay reform of the [U.S.] transfer pricing rules.

Id. at 13.

101. *Id.* at 16.

102. *See id.*

103. From a multilateral and less United-States-centric perspective, many other proposed indicators merit consideration.

104. *See generally* Avi-Yonah, *Proposal for Reconciliation*, *supra* note 17, at 6, ("I would like to propose a compromise: Use [formulary apportionment] in the context of the ALS. Specifically, I would suggest using [formulary apportionment] to allocate the residual profit in the profit split method.").

105. *See* Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem*, *supra* note 19, at 446–48.

In the unilateral context, limited formulary apportionment could be sales-based, similar to the destination-based formula for VAT.[106] This formula favors the United States because of our trade deficit, and would therefore be politically popular.[107] Similarly, flexible formulary apportionment would work well because it has the potential for considerable complexity and can be varied depending upon the degree to which the formulas implemented are narrowly tailored to specific income-producing activities.[108]

Importantly, the complexity present in limited and flexible formulary apportionment is based on objective factors. Unlike the current system, the difficult decision-making happens at rule formation rather than rule application. Therefore, an objective, narrowly-tailored hybrid formulary-arm's length system could successfully replace the complex, subjective regime currently in place.[109]

E. Merits of Adopting Limited or Flexible Formulary Apportionment

The merits of adopting a hybrid formulary-arm's length system are vast. A hybrid system would allow the IRS to continue employing an arm's length standard allocation to transactions where an easily observable and consistent market price or rate-of-return to a certain commodity or commercial-activity exists. At the same time, the IRS could calculate difficult-to-allocate MNE sources of income using a version of formulary apportionment.[110] Besides more accurately reflecting economic reality, a hybrid formulary-arm's length system would lead to greater predictability for MNEs, as well as more predictable tax revenue for the government. This increased certainty would also reduce the need for litigation.

Additionally, a hybrid formulary-arm's length system is far more reasonable from an administrability perspective. Flexible formulary apportionment in particular makes it possible to correct for potential over-allocation while also accounting for the supply-side benefit or burden, by

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106. *See generally* KRISTIAN BEHRENS ET AL., DESTINATION- VS. ORIGIN-BASED COMMODITY TAXATION AND THE LOCATION OF INDUSTRY 2–25 (2004); *see also* Reuven Avi-Yonah, *Comment on Grubert and Newlon,* "*The International Implications of Consumption Tax Proposals,*" 49 NAT. TAX J. 259 (1996).

107. *See* Avi-Yonah, *Proposal for Reconciliation*, *supra* note 17, at 17.

108. *See* Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem*, *supra* note 19, at 448.

109. *See id.*

110. *See* Reuven S. Avi-Yonah & Ilan Benshalom, *Formulary Apportionment—Myths and Prospects*: *Promoting Better International Policy by Utilizing the Misunderstood and Under-Theorized Formulary Alternative*, 3 WORLD TAX J. 371, 381 (2011) [hereinafter Avi-Yonah & Benshalom, *Formulary Apportionment*].

implementing narrowly tailored, industry-specific formulas.[111] Moreover, this approach would even allow for readily-ascertainable, economically sound, industry specific metrics for allocation. And, since the arm's length standard would remain as a sort of alternative minimum tax, adopting limited or flexible formulary apportionment would not increase gamesmanship.

Contrary to concerns voiced by critics, supplementing the arm's length standard with formulary apportionment would not violate U.S. treaty obligations.[112] Much to the contrary, improved administrability would be agreeable to our treaty partners. Since formulary apportionment is connected to economic reality, such methods would appear less arbitrary and would be conducive to cooperation of Competent Authorities. Incorporating hybrid formulary apportionment into the U.S. tax system would also support the three stated goals of the OECD's Base Erosion and Profit Shifting Action Plan: "(1) promotion of collaborative rather than competition based solutions; (2) take a holistic view of the challenges and their corresponding solutions rather than an ad hoc approach; and (3) permit the consideration of innovative solutions even when they conflict with the traditional premises of the current international tax regime."[113] Moreover, in light of the BEPS zeitgeist and

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111. *See generally* Rectenwald, *A Proposed Framework for Resolving the Transfer Pricing Problem*, *supra* note 19, at 446.

112. *See* Reuven Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009). *Contra* J. Clifton Fleming, Jr. et al., *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on A Pig?*, 36 MICH. J. INT'L L. 1, 32 (2014).

> [I]f the United States were to adopt global formulary apportionment, it would find itself (1) in a world in which its formulary system struggles to interact with the arm's-length systems prevailing in other nations, or (2) in a world of nations that have adopted global formulary apportionment but with diverse allocation formulas, or (3) in a world that chaotically conflates (1) and (2). Either way, these asymmetries between the U.S. system and the rest of the world would produce large amounts of international income that is either double-taxed or not taxed anywhere.

Id. at 32.

113. Brauner, *What the BEPS?*, *supra* note 2, at 55; *see generally* OECD, ACTION PLAN, *supra* note 2.

evolving international attitudes,[114] the United States' global influence and economic power should not be underestimated.[115]

It should be noted–despite the considerable promise shown by a hybrid formulary-arm's length system–the opportunity for regulatory arbitrage would need to be examined in greater depth prior to adoption or implementation. And, although I address the theoretical arguments in favor of a hybrid formulary-arm's length system, a study of the empirical macroeconomic effects of my proposal are beyond the scope of this paper.[116]

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114. *See generally* Reuven Avi-Yonah, *Back from the Dead: How to Revive Transfer Pricing Enforcement* (U. Mich. L. & Econ. Working Paper, 2013).

> The OECD has recently come to recognize that the transfer pricing system does not work as intended. In its report on Base Erosion and Profit Shifting, the OECD recognizes that BEPS results in revenue losses that affect all states, especially poorer ones; that systematic tax avoidance by the richest and most powerful companies in the world undermines the general legitimacy of taxation; that it gives MNEs significant competitive advantages over purely domestic firms, resulting in inefficient allocations of investment and major distortions to economic activity; and that it skews the decisions of the MNEs themselves, resulting in overall economic welfare losses.

Id. at 1.

115. *See generally* Avi-Yonah, *Proposal for Reconciliation*, *supra* note 17, at 4. Professor Avi-Yonah is demonstrating that the international community has followed the lead of the United States in the past regarding international tax policy:

> In 1995, the [U.S.] adopted new transfer pricing regulations that incorporated two new methods, the Comparable Profit Method (CPM) and Profit Split, which relied much less on comparables (CPM uses comparability very loosely and in Profit Split the residual is not allocated based on comparables). The OECD followed suit and amended the Transfer Pricing Guidelines to include the new methods.

Id. at 2

116. *See generally* Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463, 466 (2003) (providing a historical perspective on the relationship between taxation and corporate dividend policies–a nod toward potential macroeconomic effects of my proposal).

V. CONCLUSION

In conclusion, the IRS's "serbonian bog"[117] of section 482 regulations opens the door for abuse and gamesmanship while forcing the IRS to make strained claims of regulatory consistency. Since regulatory complexity breeds arbitrage, addressing tax avoidance with increasingly complex regulations is unlikely to slow the bleeding, let alone eliminate the problem.[118]

On the other hand, the Ninth Circuit's inadvertent promotion of taxpayer uncertainty, legal indeterminacy, and perverse incentives is equally inappropriate. By converting the arm's length standard from a legal principle to a legal rule, the court effectively precluded the IRS from explicitly creating narrow exceptions to the arm's length standard when appropriate and as permitted under section 482.

Recent tax regulations appear to be shaped by an assumed indeterminacy of unembellished general rules. The question is: Can more elaborate and specific provisions render the law significantly less indeterminate or vulnerable to judicial interpretation? If the *Xilinx* saga is any indication, the answer is no.

If both the IRS and the Ninth Circuit interpretations are incorrect, the U.S. should consider the merits of unilaterally adopting a hybrid formulary-arm's length system. This recommendation is compatible with existing treaty obligations as well as the OECD Base Erosion and Profit Shifting Action Plan. Further, supplementing the arm's length standard with a version of formulary apportionment has the potential to make the existing system more effective, accurate, and predictable–thereby decreasing litigation and largely eliminating the need for arbitrary *post hoc* apportionment by the IRS

Tax arbitrage has significantly reduced corporate tax revenue since 1943, increasing corporate profit margins but also increasing social costs:

> Corporate income taxes have diminished as a major source of revenue, from 39.8 [percent] in 1943 to 9.9 [percent] in 2012. The reason is not that corporations have come to play a less important role in our economy, or that corporate profitability has diminished. Rather, it is that corporations

117. *See* Charles S. Whitman III, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 HARV. L. REV. 1194 (1968) (referencing Milton's description of the Serbonian Bog in *Paradise Lost: Book II*, "where whole armies have sunk").

118. *See generally* John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 13–14 (1993).

> have learned how to exploit loopholes in our tax system, have lobbied hard and successfully to increase those loopholes, and have especially taken advantage of globalization to move profits to jurisdictions where they are lightly taxed. Tax arbitrage has become a major and highly profitable activity for firms–an activity with no social returns but high social costs.[119]

Until the existing international tax system is repaired, unsophisticated American taxpayers will be unduly burdened while MNEs successfully avoid taxation. A hybrid formulary-arm's length regime need not be flawless to be an improvement. Thus, the costs and benefits should be measured against the current regime rather than a fictionalized ideal.[120]

As economist Joseph Stiglitz asserts: "Every tax system is an expression of a country's basic values—and its politics. It translates into hard cash what might otherwise be simple high-flown rhetoric."[121] So what should the United States' transfer pricing law express? Rather than maintaining the status quo, the United States should adopt a transfer pricing system that reflects economic reality, but also embodies the *spirit* of section 482—creating parity between taxpayers.[122] Only then can we begin to restore public confidence in the fairness and efficacy of our country's tax system—and make transfer pricing jurisprudence clearer instead of "curiouser."[123]

VI. AFTERWORD

Since this Article was submitted for consideration in the Tannenwald Writing Competition on July 1, 2015, the legal landscape has shifted dramatically. On July 27, 2015, the Tax Court decided *Altera Corp. & Subsidiaries v. Commissioner*,[124] which unanimously struck down the revised

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119. Stiglitz, *Reforming Taxation to Promote Growth and Equity*, *supra* note 99

120. Avi-Yonah & Benshalom, *Formulary Apportionment*, *supra* note 110 at 381.

121. JOSEPH E. STIGLITZ, THE ROARING NINETIES: A NEW HISTORY OF THE WORLD'S MOST PROSPEROUS DECADE 177 (2003).

122. *See* Revenue Act of 1934, Art. 45-1(c) of Reg. 86 (1935) (cited in full by Essex Broadcasters, Inc. v. Commissioner, 2 T.C. 523, 531 (1943)).

123. CARROLL, ALICE'S ADVENTURES IN WONDERLAND, *supra* note 1, at 16 ("'Curiouser and curiouser!' Cried Alice (she was so much surprised, that for the moment she quite forgot how to speak good English).").

124. Altera Corp. & Subsidiaries v. Commissioner, 145 T.C. No. 3 at *2 (2015).

2003 cost-sharing regulations, holding that Treasury had not engaged in reasoned decision-making and the resulting regulations were "arbitrary and capricious and therefore invalid."[125]

Importantly, the Tax Court also held that the notice and comment requirements of the Administrative Procedure Act apply to Treasury regulations carrying the force of law.[126] Absent a reversal on appeal to the Ninth Circuit, *Altera* will likely have notable consequences far beyond the realm of related-party cost-sharing agreements. In particular, it is worth considering whether *Altera* has opened the door for regulatory challenges in other contexts where Treasury failed to articulate a reasoned basis for its decision[127] or neglected to adequately address significant taxpayer comments to proposed regulations.[128]

In a broader sense, however, *Altera* has the potential to be the first definitive step away from the Queen of Heart's "Sentence first—verdict afterward"[129] approach to the promulgation and judicial review of Treasury regulations.

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125. *Id.*

126. *Id.* at *14.

> The U.S. Court of Appeals for the Ninth Circuit, to which an appeal in these cases appears to lie absent a stipulation to the contrary . . . has held that we can infer that an agency intends for a rule to have the force of law in any of the following circumstances: "(1) when, in the absence of the rule, there would not be an adequate legislative basis for enforcement action; (2) when the agency has explicitly invoked its general legislative authority; or (3) when the rule effectively amends a prior legislative rule," . . . or "effect[s] a change in existing law or policy."

Id. at *34.

127. *Id.* at *21.

128. *Id.* at *15; *see also* Am. Mining Cong. v. EPA, 965 F.2d 759, 771 (9th Cir.1992) (citing Home Box Office v. FCC, 567 F.2d 9, 35 & n.58).

129. CARROLL, ALICE'S ADVENTURES IN WONDERLAND, *supra* note 1, at 99 (1898) ("'Let the jury consider their verdict,' the King said, for about the twentieth time that day. 'No, no!' said the Queen. 'Sentence first—verdict afterward.' 'Stuff and nonsense!' said Alice loudly. 'The idea of having the sentence first!'").