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Deterring Transfer Pricing Abuse: Changing Incentives As a Practical Alternative to a Global Tax Regime

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DETERRING TRANSFER PRICING ABUSE: CHANGING INCENTIVES AS A PRACTICAL ALTERNATIVE TO A GLOBAL TAX REGIME

I. INTRODUCTION

Recent tax scandals have involved individuals hiding money in off-shore accounts, hopefully never to be discovered by the U.S. Internal Revenue Service ("IRS"). This conduct is clearly illegal. Multinational businesses, however, have been avoiding taxes by moving money internationally for decades. The difference between a company's tax avoidance procedures and illegal tax evasion is that these multinational businesses have become very adept at remaining within the letter of the law in various nations when shifting income.

Transfer pricing is a practice whereby companies use transactions between different corporate units to shift income between jurisdictions for the purpose of reducing the company's overall tax burden.[1] An international company can theoretically choose to pay income taxes in the country of its choice by shifting income from one unit of the company located in a country with a relatively high corporate income tax rate to another unit located elsewhere with a lower tax rate. As might be expected, the "high tax" countries are not content to stand idly by as their tax base erodes out from underneath their feet. The United States, as one of the relatively higher-tax countries, has enacted a variety of laws and regulations to try to ensure that international companies accurately apportion their income among the countries where they conduct business.[2]

1. *See* BLACK'S LAW DICTIONARY 1309 (9th ed. 2009). The following is an example of how a transfer pricing scheme might work:

> [A] company . . . that makes widgets [creates] a subsidiary, S1, to perform the actual manufacturing in high-tax country A. The widgets cost $60 to produce. S1 sells the widgets for $62 to a related company, S2, which is a resident in tax haven Country B. S2 sells the widgets for $80 to S3, yet another related company residing in the United States. S3 distributes the widgets throughout the U.S. market, selling them to unrelated U.S. customers at an average of $90, after incurring expenses of about $5 per widget. Of the $25 of combined profits per widget, S1 reports and pays taxes on $2 in A. S3 pays taxes on its profit of $ 5 per widget in the United States. S2 reports $18 of the profit and is taxable only in B, which levies very little tax.

Julie Roin, *Can The Income Tax Be Saved? The Promise and Pitfalls of Adopting World-Wide Formulary Apportionment*, 61 TAX L. REV. 169, 181 (2008).

2. The beginning of this long maze of rules can be found at I.R.C. § 482 (2006), which provides the overarching goal of preventing tax evasion through accurately apportioning income between entities that conduct transactions with each other. *See* discussion *infra* Part II.B.

While the intended legal framework for transfer pricing is not difficult to define in broad strokes, the actual detailed implementation of the necessary laws and regulations in each nation has proven to be extraordinarily difficult. With billions of dollars at stake, international businesses have a huge financial incentive to find ways to reduce their tax burden while still staying within the letter of various nations' laws.

This Note proposes a change to the jurisdiction of the U.S. Tax Court and discusses why such a change would deter businesses from engaging in overly aggressive tax-avoidance behavior. First, in Part II it provides an initial example of the problem of transfer pricing by explaining how a multinational enterprise, IKEA, uses a carefully planned corporate structure to greatly reduce its tax burden. It then provides an introduction to how one nation, the United States, addresses corporations that shift income between countries. Next, it addresses in Part III how the global tax system might be reformed and whether such reform would effectively prevent tax evasion by allocating income to countries with a lower tax. In Part IV, using the U.S. tax regime as an example, the Note suggests modifications to national tax regimes that will deter transfer pricing abuses, including the requirement that Article III courts, where there is the prospect of a jury as the fact-finder, have exclusive jurisdiction over transfer pricing disputes. The Note concludes in Part V.

II. TRANSFER PRICING PERMITS INTERNATIONAL COMPANIES TO AVOID TAXES

The concept of an "international tax system" is an illusion. The current reality is one of independent states attempting to tax international activities by casting a net woven from a mixture of each country's domestic tax laws and bilateral tax treaties.[3] Not surprisingly, the lack of a

3. "Basically, there are three sets of international tax rules: (1) the domestic rules dealing with taxation of non-residents, (2) the domestic rules dealing with taxation of residents generating income abroad, and (3) some complementary rules (that are not purely domestic and are mainly found in tax treaties) . . . ." Yariv Brauner, *An International Tax Regime in Crystallization*, 56 TAX L. REV. 259, 265–66 (2003). An international income tax system usually contains:

> several layers of rules that apply to transactions and taxpayers independent of each other, but in a certain, rigid order. These sets of rules, in that order, are: (1) definition of "income" subject to tax, (2) measurement of the tax base and transfer pricing rules, (3) classification of types of income, (4) source (and allocation) rules, (5) taxing provisions, including rates and timing, (6) relief of domestic taxation under domestic rules, (7) relief of domestic taxation claiming tax treaty benefits, and (8) means of collection—mainly withholding tax rules.

Id. The system is currently made up of about 1,500 bilateral tax treaties. *Id*. at 292. Although the sheer number of treaties may lead one to believe otherwise, there is already a degree of harmonization uniform system can lead to problems in taxing international entities as nations originally intended under their current "international" tax systems. The possibility of over or under taxation affects businesses' incentives, which in turn affects their decision-making processes and often leads to losses in economic efficiency.[4] One tax avoidance practice used by multinational businesses is transfer pricing.

Of course, many countries, including the United States, have adopted rules to try to prevent abusive transfer pricing.[5] Some of the tax law unrelated to transfer pricing can reduce the impact of the tax avoidance rules, such as the taxpayer's choice of court in the United States. Even the most comprehensive national regulations, however, permit international businesses, like IKEA, to take advantage of gaps in tax regimes because transfer pricing is a uniquely international—not national—tax issue.

A. An Example of Transfer Pricing and Tax Avoidance: IKEA

IKEA is a large multinational retailer that specializes in relatively inexpensive home furnishings.[6] Even though it is a worldwide retailer, the IKEA group is not organized as a corporation, but rather as a Dutch charitable non-profit organization.[7] Although this charity, the Stichting Ingka Foundation,[8] applies only a small fraction of its wealth to its stated purpose,[9] it does allow the IKEA group to keep much of what it earns in a

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among these treaties. *See, e.g.*, *id*. at 271 (noting harmony in various jurisdictions' definition of income tax base). *But see id*. at 284 ("[H]armonization of the tax rates is . . . impractical . . . .").

4. *See id*. at 291. In addition, a government's inability to collect revenue as intended from international businesses also leads to equity issues for wholly domestic entities. Diane Ring, *Democracy, Sovereignty and Tax Competition: The Role of Tax Sovereignty in Shaping Tax Cooperation*, 9 FLA. TAX REV. 555, 576 (2009). If the government cannot collect revenue from the international businesses, it is forced "to either reduce [its] services and benefits, or alternatively, increase taxes on a less mobile base—typically employment and consumption." *Id.* "Either option potentially levies an increased burden on a subset of society . . . .").

5. Brauner, *supra* note 3, at 274.

6. IKEA states that its business concept is "[t]o offer a wide range of well designed, functional home furnishing products at prices so low that as many people as possible will be able to afford them." *Facts & Figures Yearly Summary*, IKEA 6 (2011), http://www.ikea.com/ms/en_CA/pdf/yearly summary/welcome_inside_2011.pdf.

7. *IKEA: Flat-pack Accounting*, THE ECONOMIST, May 13, 2006, at 69, 69. "*Stichtingen*, or foundations, are the most common form of not-for-profit organisation in the Netherlands; tens of thousands of them are registered. Most Dutch *stichtingen* are tiny . . . ." *Id*.

8. The foundation likely gets its name from a contraction of the name of IKEA's founder, Ingvar Kamprad. In 2006, *The Economist* estimated that it was worth $36 billion. *Id*.

9. The Stichting Ingka Foundation is "dedicated to 'innovation in the field of architectural and interior design.' [sic] The articles of association . . . state that this object cannot be amended. Even a Dutch court can make only minor changes to the *stichting's* aims." *Id*.

> Under its articles, Stichting Ingka Foundation channels its funds to Stichting IKEA Foundation, another Dutch-registered foundation with identical aims, and which actually

tax-exempt entity.[10] The Stichting Ingka Foundation owns a private Dutch company, Ingka Holding,[11] which in turn is the parent of almost every other IKEA company.[12]

Furthermore, separate from this group of companies, another private Dutch company, Inter IKEA Systems, owns the IKEA trademark and concept.[13] Each IKEA store pays three percent of its sales to this company as a royalty for the use of IKEA's intellectual property.[14] The royalties paid to Inter IKEA Systems are transferred through a chain of similarly named companies and eventually end up being administered by a trust company in Curaçao, an island in the Dutch Caribbean, which refuses to name the beneficiaries of the trust.[15] At the end of this chain of transactions, the unnamed beneficiaries have access to the proceeds from the intellectual property royalties.[16] Thus, the three percent of sales from each store that would likely otherwise have been taxable income do not end up taxed in the country where IKEA furniture was actually bought and sold.

The practice of a company shifting income by charging itself for the use of its own intellectual property is certainly not limited to IKEA.[17] Yet,

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> doles out money for worthy interior-design ideas. But the second foundation does not publish any information either. . . . IKEA says only that this money is used for charitable purposes and "for investing long-term in order to build a reserve for securing the IKEA group, in case of any future capital requirements." IKEA adds that in the past two years donations have been concentrated on the Lund Institute of Technology in Sweden. The Lund Institute say it has recently received SKr12.5m ($1.7m) a year from Stichting IKEA (which also gave the institute a lump sum of SKr55m in the late 1990s). That is barely a rounding error in the foundation's assets.

Id. at 70.

10. *Id*. at 69.

11. Ingka Holding is a private Dutch company. *Id*. at 69. It owns many of the 287 IKEA stores directly, while the remaining stores are owned by franchisees. *Facts & Figures*, *supra* note 6, at 22.

12. *IKEA: Flat-pack Accounting*, *supra* note 7, at 69. For a graphical example of IKEA's structure, *see Ikea's Duthch* [sic] *Trick*, http://www.altreconomia.it/allegati/contenuti/phpmqcMPA5076.pdf (last visited Feb. 18, 2010).

13. *IKEA: Flat-pack Accounting*, *supra* note 7, at 70.

14. "Inter IKEA earns its money from the franchise agreements it has with each IKEA store. These are extremely lucrative: IKEA says that all franchisees pay 3% of sales." *Id*.

15. Inter IKEA Systems' "parent company is Inter IKEA Holding, registered in Luxembourg. This, in turn, belongs to an identically named company in the Netherlands Antilles, run by a trust company in Curaçao. Although the beneficial owners remain hidden from view . . . they are almost certain to be members of the Kamprad family." *Id*.

16. *Id*.

17. For example, in 2006, GlaxoSmithKline PLC, a British company settled a transfer pricing dispute with the IRS for $3.4 billion:

> The case . . . involved the way Glaxo paid taxes on U.S. profits from such popular drugs as Zantac, a stomach remedy, Imitrex, for treatment of migraines, and Ceftin, an antibiotic. At issue was one of the thorniest concerns facing tax collectors—how multinational corporations

IKEA's system might be considered a more aggressive use of this practice.[18] To understand how such tax-avoiding transactions are allowed, one must have a basic grasp of the international tax system.

B. An Example of a National Transfer Pricing Regime: The United States

The United States is a common law jurisdiction that utilizes statutes and regulations to state the tax rules. Taxpayers may challenge tax rules applied to them in court. Courts will decide the legality of the taxpayer's position in accordance with the statutes and regulations. Currently, in the United States, strategic tax planning includes choosing which court hears the case.

1. U.S. Statutes and Regulations

The statute governing transfer pricing is found in § 482 of the Internal Revenue Code, which gives the IRS the authority to "distribute, apportion, or allocate gross income, deductions, credits, or allowances . . . if [it] determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly . . . reflect . . . [the taxpayer's] income . . . ."[19] In 1986, thirty-two years after enacting

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> apportion profits and expenses among units in different countries. The IRS has said that companies often manipulate cross-border transactions to minimize taxes.
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> . . . .
>
> The IRS had alleged that [GlaxoSmithKline] had allotted too little of its profits from worldwide drug sales to its U.S. subsidiary. Determining the proper split in what are known as "transfer pricing" cases can involve apportioning such intangible items as the value of trademarks and brand names.

David S. Hilzenrath, *Glaxo to Pay IRS $3.4 Billion*, WASH. POST, Sept. 12, 2006, at D1, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/09/11/AR2006091100429.html.

18. Even with the examples such as GlaxoSmithKline, *supra* note 17, companies are still shifting income to a lower-tax country. IKEA not only shifts its income, but then through a series of subsequent transactions, it ends up paying only about 3.5% in taxes. *See IKEA: Flat-pack Accounting*, *supra* note 7, at 70.

19. I.R.C. § 482 (2006). The full statute provides:

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits or allowances between or among such organizations, trades, or 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 (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Id.

§ 482,[20] the U.S. Congress recognized that transfer pricing issues involving intangible property, like trademarks, were especially problematic.[21] Congress added a provision that "the income with respect to [the transfer or licensing of intangible property] shall be commensurate with the income attributable to the intangible."[22]

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20. Section 482 was first enacted in 1954. Pub. L. No. 83-591, 68A Stat. 3 (codified as amended at I.R.C. § 482 (2006)).

21. The legislative history of § 482's second sentence makes clear that Congress recognized the uniquely difficult problem presented by intangible property. H.R. REP. NO. 99-426 (1985), *reprinted in* 5 TAX REFORM 1986: A LEGISLATIVE HISTORY OF THE TAX REFORM ACT OF 1986, at 423. In a section entitled "Reasons for Change," Congress noted:

> There is a strong incentive for taxpayers to transfer intangibles to related foreign corporations in a low tax jurisdiction, particularly when the intangible has a high value relative to manufacturing or assembly costs. Such transfers can result in indefinite tax deferral or effective tax exemption on the earnings, while retaining the value of the earnings in the related group. The committee is concerned that the provisions of sections 482, 367(d), and 936 that allocate income to a U.S. transferor of intangibles may not be operating to assure adequate allocations to the U.S. taxable entity of income attributable to intangibles in these situations.

Id. Regarding § 482 specifically, the House Ways and Means Committee added:

> Many observers have questioned the effectiveness of the "arm's length" approach of the regulations . . . . A recurrent problem is the absence of comparable arm's length transactions between unrelated parties, and the inconsistent results of attempting to impose an arm's length concept in the absence of comparables. A fundamental problem is the fact that the relationship between related parties is different from that of unrelated parties. Observers have noted that multinational companies operate as an economic unit, and not "as if" they were unrelated to their foreign subsidiaries . . . . The problems are particularly acute in the case of transfers of high-profit potential intangibles. Taxpayers may transfer such intangibles to foreign related corporations or to possession corporations at an early stage, for a relatively low royalty, and take the position that it was not possible at the time of the transfers to predict the subsequent success of the product. Even in the case of a proven high-profit intangible, taxpayers frequently take the position that intercompany royalty rates may appropriately be set on the basis of industry norms for transfers of much less profitable items.

Id. at 423–24 (citations omitted). To attempt to address the problem, the "commensurate with income" standard was added to § 482. *See id.* at 425. The Ways and Means Committee explained the logic behind the change:

> Transfers between related parties do not involve the same risks as transfers to unrelated parties. There is thus a powerful incentive to establish a relatively low royalty without adequate provisions for adjustment as the revenues of the intangible vary. There are extreme difficulties in determining whether the arm's length transfers between unrelated parties are comparable. The committee thus concludes that it is appropriate to require that the payment made on a transfer of intangibles to a related foreign corporations or possessions corporations be commensurate with the income attributable to the intangible. . . . The committee believes, therefore, that this is the measure that should be used under . . . section 482 in the case of transfers to a foreign corporation.

Id. at 425.

22. I.R.C. § 482 (2006). Section 482 is only two sentences long. Congress added the second sentence pertaining to intangible property in 1986, thirty years after the first sentence. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2562 (codified as amended at 42 U.S.C. § 482 (2006)). Like the first sentence, the second sentence basically leaves it to the IRS to implement a workable solution: "[i]n the case of any transfer (or license) of intangible property (within the meaning of section

The U.S. Department of Treasury regulations interpreting § 482 state that its purpose "is to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such transactions."[23] In general terms, a "controlled transaction" simply refers to a transaction between two parties that are both under the same entity's control.[24] This purpose is accomplished by ensuring "tax parity," meaning comparable tax treatment, between a taxpayer who is part of a controlled transaction and one who is not.[25] The key to achieving parity between the two is to "determin[e] the true taxable income of the controlled taxpayer"[26] and reallocate income "between or among the members of a controlled group if [the] controlled taxpayer has not reported its true taxable income."[27]

936(h)(3)(b)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." *Id*. The cross-referenced section states:

> The term 'intangible property' means any—(i) patent, invention, formula, process, design, pattern, or know-how; (ii) copyright, literary, musical, or artistic composition; (iii) trademark, trade name, or brand name; (iv) franchise, license, or contract; (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (vi) any similar item, which has substantial value independent of the services of any individual.

I.R.C. § 936(h)(3)(b) (2006).

23. Treas. Reg. § 1.482-1T (2009).

24. The actual definition given by the Treasury, which is much more detailed, is available at Treas. Reg. § 1.482-1(i) (2009). A controlled transaction is a "transaction or transfer between two or more members of the same group of controlled taxpayers." Treas. Reg. § 1.482-1(i)(8) (2009). "Group, controlled group, and group of controlled taxpayers mean the taxpayers owned or controlled directly or indirectly by the same interests." Treas. Reg. § 1.482-1(i)(6) (2009) (emphasis omitted). A controlled taxpayer is "any one of two or more taxpayer owned or controlled directly or indirectly by the same interests, and includes the taxpayer that owns or controls the other taxpayers." Treas. Reg. § 1.482-1(i)(5) (2009). The definition of "control" ensures to cast a wide net. *See* Treas. Reg. § 1.482-1(i)(4) (2009). Control is broadly defined as "any kind of control, direct or indirect, whether legally enforceable or not . . . including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose." *Id.* Ensuring that creative lawyers cannot use form to defeat substance, the definition further states "[i]t is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted." *Id*. Covering all the bases, a taxpayer is defined as "any person, organization, trade or business, whether or not subject to any internal revenue tax." Treas. Reg. § 1.482-1(i)(3) (2009). The term "[o]rganization includes an organization of any kind . . . irrespective or the place of organization, operation, or conduct of the trade or business . . . ." Treas. Reg. § 1.482-1(i)(1) (2009). Lastly, a "[t]rade or business includes a trade or business activity of any kind, regardless of whether or where organized . . . and regardless of the place of operation." Treas. Reg. § 1.482-1(i)(2) (2009).

25. 26 C.F.R. § 1.482-1T (a)(1) (2009).

26. *Id*.

27. Treas. Reg. § 1.482-1(a)(2) (2009). "In such case, the district director may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income . . . . The appropriate allocation may take the form of an increase or decrease in any relevant amount." *Id.*

The IRS's standard to determine a controlled taxpayer's true taxable income is the "arm's length standard."[28] The arm's length standard is based on the principle that income reported by related parties involved in a transaction should be the same as independent parties who engage in the same transaction under the same circumstances." [29] Since it is nearly impossible to recreate the exact same situation twice, however, "whether a transaction produces an arm's length result . . . [is] determined by reference to the results of comparable transactions under comparable circumstances."[30] Treasury regulations specify a variety of detailed methods for determining what is "comparable"[31] and require the use of the

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28. Treas. Reg. § 1.482-1(b)(1) (2009) ("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 engaged in the same transaction under the same circumstances . . . .").

29. *Id*.

30. *Id*.

31. For cases like IKEA and GlaxoSmithKline, *supra* note 17, where the internal transfer involves intangible property, the Treasury provides four methods to choose from. Treas. Reg. § 1.482-4(a) (2009). The first is the "comparable uncontrolled transaction method[, which] evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction." Treas. Reg. § 1.482-4(c) (2009). The second is the "comparable profits method[, which] evaluates whether the amount charged in a controlled transaction is arm's length based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances." Treas. Reg. § 1.482-5(a) (2009).

> Under the comparable profits method, the determination of an arm's length result is based on the amount of operating profit that the tested party would have earned on related party transactions if its profit level indicator were equal to that of an uncontrolled comparable (comparable operating profit). Comparable operating profit is calculated by determining a profit level indicator for an uncontrolled comparable, and applying the profit level indicator to the financial data related to the tested party's most narrowly identifiable business activity for which data incorporating the controlled transaction is available (relevant business activity). . . . The tested party's reported operating profit is compared to the comparable operating profits derived from the profit level indicators of uncontrolled companies to determine whether the reported operating profit represents an arm's length result.

Treas. Reg. § 1.482-5(b)(1) (2009). Third:

> The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

Treas. Reg. § 1.482-6(a) (2009). Finally, a taxpayer is given the nebulous guidance that "[m]ethods not specified in . . . this section may be used to evaluate whether the amount charged in a controlled transaction is arm's length." Treas. Reg. § 1.482-4(d)(1) (2009). This "catch-all" provision states:

> Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular

test that "provides the most reliable measure of an arm's length result."[32] The simple instruction that companies pick "the most reliable measure" provides one straightforward and lawful opportunity for companies to take advantage of the inexact nature of the arm's length standard by using the method that permits the most tax avoidance. Moreover, the law's choice of forum permits companies to gain an advantage by choosing a forum with the most favorable ground rules for them.

2. U.S. Courts and Choice of Forum

In the United States, the structure of the court system itself plays a significant role in the functioning of the tax system. When the IRS determines that a taxpayer has under-allocated its income attributable to the United States, the taxpayer has three options to contest that determination.[33] In theory, the taxpayer chooses among the U.S. Tax Court, the Federal Claims Court, or a federal district court.[34] In practice, however, the tax system heavily incentivizes taxpayers to choose the United States Tax Court because it is the only method by which a taxpayer

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> transaction if none of the alternatives is preferable to it. . . . [I]n establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction.

Id.

32. This test is referred to as the "best method rule." Treas. Reg. § 1.482-1(c)(1) (2009).

> The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

Id. Applying this to the four standards provided for transactions involving intangible property could be especially difficult considering the possibility that the "best method" a taxpayer should have used was an "unspecified method." *See id*.

33. Congress set the baseline by providing:

> The district court shall have original jurisdiction, concurrent with the United States Claims Court, of . . . [a]ny civil action against the United States for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or any penalty claimed to have been collected with authority or any sum alleged to have been excessive or in any manner wrongfully collected under the internal-revenue laws . . . .

28 U.S.C. § 1346(a)(1) (2006). *See also* 17 CHARLES ALAN WRIGHT, ARTHUR R. MILLER, EDWARD H. COOPER & VIKRAM DAVID AMAR, FEDERAL PRACTICE AND PROCEDURE § 4102 (3d ed. 2009).

34. 28 U.S.C. § 1346(a)(1) (2006).

does not have to pay the contested tax up front.[35] Once the taxpayer elects to go before the Tax Court, a court created by Congress under Article I of the U.S. Constitution ("Article I court"), the taxpayer loses the option of later going before a federal district court, a court created by Congress under Article III of the U.S. Constitution ("Article III court").[36]

Congress created the Tax Court in its current form as an Article I court as part of the Tax Reform Act of 1969.[37] The Tax Court has nineteen

35. I.R.C. § 7422 (2006). The statute gives the general rule:

> No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed . . . .

I.R.C. § 7422(a) (2006). The statute then carves out an exception to the general prepayment rule:

> If the [IRS] prior to the hearing of a suit brought by a taxpayer in a district court or the United States Court of Federal Claims for the recovery of any income tax . . . (or any penalty relating to such taxes) mails to the taxpayer a notice that a deficiency has been determined in respect of the tax which is the subject matter of the taxpayer's suit, the proceedings in taxpayer's suit shall be stayed during the period of time in which the taxpayer may file a petition with the Tax Court for a redetermination of the asserted deficiency, and for 60 days thereafter.

I.R.C. § 7422(e) (2006). In Flora v. United States, 357 U.S. 63, 75–76 (1958), the Supreme Court recognized:

> [w]here the time to petition [the tax] court has expired, or where for some other reason a suit in the District Court seems more desirable, the requirement of full payment may in some instances work a hardship . . . . [A]ny hardship would grow out of an opinion whose effect Congress in successive statutory revisions has made no attempt to alter . . . .

36. Section 7422 of the tax code divests the non-chosen courts of jurisdiction by providing:

> If the taxpayer files a petition with the Tax Court, the district court or the United States Court of Federal Claims, as the case may be, shall lose jurisdiction of taxpayer's suit to whatever extent jurisdiction is acquired by the Tax Court of the subject matter of taxpayer's suit for refund.

I.R.C. § 7422(e). *See also* Flora, 357 U.S. at 75 (1958) ("[T]he legislative history of 28 U.S.C. 1346(a)(1) and related statutes leaves no room for contention that their broad terms were intended in any way to alter the . . . principle of 'pay first and litigate later.' . . . To ameliorate the hardship produced by these requirements Congress created a special court where tax questions could be adjudicated in advance of any payment."); Kaffenberger v. United States, 314 F.3d 944, 958 (8th Cir. 2003) ("Full payment of a tax assessment is a prerequisite to suit in federal district court; taxpayers may bring prepayment suits only in United States Tax Court. Without full payment of the assessment, the district court lacks subject matter jurisdiction . . . ." (citations omitted)).

37. I.R.C. § 7441 (2006) ("There is hereby established, under Article I of the Constitution of the United States, a court of record to be known as the United States Tax Court."). As one academic observed:

> The Tax Reform Act of 1969 dramatically and significantly changed the nature of the Tax Court . . . . [It] changed the classification . . . from an agency of the executive . . . to a specialized legislative court under Article I of the United States Constitution. This . . . made the Tax Court an independent tribunal that was (and is) separate and distinct from the IRS.

David Laro, *Panel Discussion: The Evolution of the Tax Court As An Independent Tribunal*, 1995 U. ILL. L. REV. 17, 22 (1995).

judges appointed for a term of fifteen years.[38] The court has its headquarters in Washington D.C., but hears cases in cities across the country.[39] Often, only one judge hears cases[40] and, unlike Article III courts, there is no possibility of having a jury hear the case in Tax Court.[41] Thus, although which court hears the case is the taxpayer's "choice," over ninety-five percent of tax cases are heard by a judge in the United States Tax Court because the financial incentive is so strong.[42]

C. An International Issue: Transfer Pricing Plagues Many Nations

The United States is certainly not the only country to struggle in its fight against tax avoidance through transfer pricing.[43] Many nations struggle with taxing international business transactions. The thirty-three[44]

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38. I.R.C. § 7443(a) (2006). The judges are appointed by the President. I.R.C. § 7443(b) (2006). They can only be removed from office "by the President, after notice and opportunity for public hearing, for inefficiency, neglect of duty, or malfeasance in office, but for no other cause." I.R.C. § 7443(f) (2006).

39. I.R.C. § 7445 (2006) ("The principal office of the Tax Court shall be in the District of Columbia, but the Tax Court or any of its divisions may sit at any place within the United States."). In addition, I.R.C. § 7446 provides:

> The times and places of the sessions of the Tax Court and of its divisions shall be prescribed by the chief judge with a view to securing reasonable opportunity to taxpayers to appear before the Tax Court or any of its divisions, with as little inconvenience and expense to the taxpayers as practicable.

I.R.C. § 7446 (2006).

40. *See* I.R.C. § 7444(c) (2006) ("The chief judge may from time to time divide the Tax Court into divisions of one or more judges . . . .").

41. Statland v. United States, 178 F.3d 465, 472–73 (7th Cir. 1999), *cert. denied*, 528 U.S. 1155 (2000) ("[T]he right to a jury trial does not apply to civil actions against the United States. Our Circuit and others have held that there is no right to a jury trial in the tax court." (internal citations omitted)); Hawkins v. Comm'r, 85 T.C.M. (CCH) 1530, 1534 (2003) ("[I]t is well established that there is no constitutional right to a jury trial in a suit concerning Federal tax liability in the Tax Court." (citations omitted)).

The fact that the Tax Court uses judges and not juries is important because of the effects this has on people considering the risks of litigation. This Note assumes that the Tax Court is a fair and independent body. *See generally* Laro, *supra* note 37, at 24–29.

42. Laro, *supra* note 37, at 18 ("The ability of a taxpayer to litigate in the Tax Court without a prior payment of tax is the primary reason many taxpayers choose to pursue a tax dispute with the IRS in the Tax Court."). This incentive system has also not gone unnoticed by the court. *See, e.g.*, Cupp v. Comm'r of Internal Revenue, 65 T.C. 68, 86 (1975) ("[W]here a taxpayer takes advantage of the procedure of filing a petition in the Tax Court without payment of the tax, any deprivation of a jury trial is due to his own act. If a taxpayer desires a jury trial, he must pay the tax and sue for refund thereof." (internal citation omitted)).

43. Ilan Benshalom, *Sourcing the "Unsourceable": The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631, 643–44 (2007) (internal citation omitted) ("[L]imited success [of other Western countries] came only at the grave price of tremendous efficiency, compliance, administrative, and litigation costs.").

44. The OECD currently has thirty-four of the major trading nations as its members. *List of OECD Members—Ratification of the Convention on the OECD*, ORGANIZATION FOR ECONOMIC

other industrialized nations that are members of the Organization for Economic Cooperation and Development ("OECD"), like the United States, also use the arm's length standard.[45] Additionally, developing nations that are not members of the OECD take advantage of the OECD guidance and utilize the arm's length standard for taxing transactions from multinational enterprises.[46]

The arm's length standard is not, in itself, a poor standard.[47] The problems with the arm's length standard occur in determining how to best apply it.[48] The OECD alone offers five methods of application[49] and is still indecisive as to which method is preferred.[50] The standard can quickly become a fact-intensive dispute where the information needed to determine the value of a comparable arm's length transaction and resolve the dispute may not exist.[51]

As shown with IKEA, the lack of available information from which to derive a "correct" price for an internal business transaction is even more difficult when intangible property is involved.[52] Additionally, oftentimes

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COOPERATION AND DEVELOPMENT ("OECD"), http://www.oecd.org/document/58/0,3746,en_2649_201185_1889402_1_1_1_1,00.html (last visited Jan. 1, 2012) ("Twenty countries originally signed the Convention on the Organisation for Economic Co-operation and Development on 14 December 1960. Since then fourteen countries have become members of the Organisation.").

45. Caroline Silberstein, *Transfer Pricing: A Challenge for Developing Countries*, OECD OBSERVER, Dec. 2009-Jan. 2010, at 29, *available at* http://www.oecdobserver.org/news/fullstory.php/aid/3131/Transfer_pricing:_A_challenge_for_developing_countries.html.

46. *Id.* at 31.

47. Benshalom, *supra* note 43, at 644.

48. Silberstein, *supra* note 45, at 29–30.

49. ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS (Aug. 18, 2010); *see also* Silberstein, *supra* note 45, at 29–30 (providing a brief description of the five basic methods and complications regarding intangibles).

50. Silberstein, *supra* note 45, at 30–31 (indicating that, as recently as 2010, the OECD considered endorsing different methods of applying the arm's length standard that were previously considered inferior "last resort" methods).

51. Benshalom, *supra* note 43, at 643 ("[T]ransfer pricing rules have a penumbra of abuse possibilities.").

52. *See* Silberstein, *supra* note 45, at 30 (noting that "comparables can be scarce" for intangibles); Benshalom, *supra* note 43, at 647. Benshalom stated, "Many complex affiliated commercial transactions involving informational products lack market comparables precisely because they would not be efficient in unaffiliated settings." *Id*. Additionally:

> [a]ffiliated transactions related to intangible assets are difficult to appraise in accordance with an arm's-length standard because of several inherent characteristics of these assets. First, transactions related to intangible assets often lack market comparables. Second, intangibles also have (1) a high-risk nature, which essentially means that their value and correlative risks cannot be accurately inferred from the costs incurred in their creation, and (2) an enormous value variation to users operating in different jurisdictions and economic environments. Additionally, there is no market for many information assets. Accordingly, the value of many

there is not a clear line between transfer pricing abuse involving tangible assets and abuse involving intangible assets. Intra-business licensing of intellectual property, such as IKEA's three percent royalty for their trademark and concept, allows companies to use intangible asset costs to undercut taxation of tangible sales and manufacturing activities.[53] Even for transactions where only intangibles are involved, it can be very difficult to say definitively what an objectively correct, or arm's length, valuation should be.[54]

Of course, even a discussion of disputes involving transfer pricing relies on the questionable assumption that the government will discover the issue at all. The present tax regimes—disjointed and state-specific—offer many opportunities for multinational enterprises to shift income without the taxing nation ever knowing that the enterprise even had the opportunity to do so.

III. PREVENTING TRANSFER PRICING THROUGH A GLOBAL TAX REGIME: FORMULARY APPORTIONMENT AS AN ALTERNATIVE

Some scholars have suggested using a global-oriented approach to taxation, namely, "formulary apportionment."[55] Formulary apportionment focuses on the worldwide net income of a business, regardless of where the income is earned, by taking a corporation's worldwide income and subtracting its worldwide expenses.[56] Then, using a formula comprised of various factors to determine each country's share, the income is apportioned among the countries where the business operates. Finally, each country's domestic tax rates are applied to that country's portion of the income.[57] Thus, formulary apportionment attempts to prevent a business from lowering its tax burden by shifting income to its companies in low-tax jurisdictions.[58]

> intangible assets, especially those inchoate and untested assets that are still in the process of formation, cannot be appreciated with precision even by [multinational enterprises'] insiders.

Id. at 649.

53. *Id*. at 647.

54. There is often a lack of comparable transactions by which to make such a determination. *Id*. at 649.

55. *See, e.g.*, Reuven S. Avi-Yonah et al., *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497 (2009).

56. *Id.*

57. *Id*. at 11.

58. *Id*. at 10.

A. Successful Formulary Apportionment: Defining Key Concepts

There are two key questions that must be answered for a system of formulary apportionment to work: (1) what is considered a business, and (2) what is the apportionment formula. This Note does not cover the normative discussions of what the definitions should be, but rather it provides a brief introduction to the issues involved to best explain formulary apportionment.

The first key concept is how to define a "business."[59] Multinational corporations, like IKEA, are often comprised of smaller distinct legal entities that are connected by various financial or operational ties.[60] To achieve the objectives of formulary apportionment, an optimal definition would balance the need for an expansive definition that prevents circumvention through careful corporate-structuring[61] with a sufficiently specific definition that minimizes its impact on business decisions.[62]

Second, the formula for apportioning a company's income between jurisdictions needs to be defined. This formula could be based entirely on one factor, such as sales, or on a mixture of several factors, such as property, payroll, and sales, each of which could be weighted equally.[63] Deciding what factors to use requires a careful balancing of interests. If the formula includes property and payroll, it will discourage companies from having assets and employees in high-tax locations to avoid high taxes. If, however, sales revenue is the only factor, export-intensive jurisdictions may feel undercompensated for the use of their infrastructure, and current "tax-haven" countries would strongly resist the likely loss of revenue they would experience.[64]

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59. "[A] difficult implementation issue in adopting [formulary apportionment] is how to define a unitary business. Current [I.R.C. § 482] . . . merely requires direct or indirect control among related parties, without even a precise definition of what control requires such as is found in other [I.R.C.] provisions." *Id*. at 24.

60. For a good visual depiction of this, see *Ikea's Duthch Trick*, *supra* note 12.

61. This concern represents the first side of a careful balancing act:

> While it is possible that taxpayer[s] may try to avoid taxation by using "independent" distributing agents for their sales, it is unlikely that they would be willing to relinquish real control over their marketing and distribution activities . . . . [W]e would adopt a look-through rule that would regard any sales made by a [multinational business] to an unrelated distributor as sales made into the U.S. if the distributor in fact sells the goods into the U.S. and does not substantially transform them before they are resold. This would prevent [the multinational business] from avoiding tax by selling their goods into the U.S. via unrelated "strawmen" who would themselves have minimal profits.

Avi-Yonah & Clausing, *supra* note 56, at 25.

62. *See id*. at 24.

63. *Id*. at 11. The use of sales as a factor is the "so called 'Massachusetts formula.'" *Id.*

64. *See id*. at 34–35.

Since formulary apportionment requires worldwide cooperation, finding a workable formula for all countries and corporate interests involved would be undoubtedly a difficult task.[65]

B. Benefits of Formulary Apportionment

Notwithstanding the difficulty of defining business and an acceptable apportionment formula, one of the major benefits of a formulary apportionment would be the degree of tax sovereignty it would allow each country to maintain. Formulary apportionment does not dictate the tax rates for each country and arguably gives countries greater freedom in setting tax policy.[66] Neither countries "who consider their tax systems to be significant, attractive features of their total business climate," nor countries which place "a high priority on maintaining their social welfare systems" would lose the ability to implement their preferred tax policy by setting their own tax rates to their allocated portion of transactions from multinational enterprises.[67]

Another benefit of formulary apportionment is its reduced emphasis on the corporate structure of a business, which reduces distortion of business incentives and decision-making processes in tax laws.[68] Businesses would experience an increase in efficiency because the simpler system would reduce the need to expend resources on tax planning.[69]

65. *Id*.

66. Under formulary apportionment, a business theoretically cannot lessen its tax burden by using transfer pricing to shift income to another country. Rather the company will be taxed in the country where the sale occurred, labor is worked, or the company's property is located, depending upon the factors used in the formula. Even though a business may ultimately reap less profit from sales in high-tax jurisdictions, under formulary apportionment, the business does not gain by shifting those sales to a low-tax jurisdiction assuming the cost and sales price for the transaction are the same in each jurisdiction. If the company can increase sales in the low-tax jurisdiction, it has no reason not to do so while still selling in the higher-tax country. *See id*. at 14–15.

67. *See e.g.,* Ring, *supra* note 4, at 568–69 (describing why both high-tax and low-tax EU countries would resist a loss of tax sovereignty). In any democratic system,

> [t]he wishes of voters . . . influence the ideal size of government, required revenue needs, and the allocation of the tax burden among subgroups within society. Under [formulary apportionment], governments would be able to choose their own corporate tax rate based on their assessment of these sorts of policy goals, rather than the pressures of tax competition for an increasingly mobile capital income tax base.

Avi-Yonah & Clausing, *supra* note 56, at 15–16.

68. Formulary apportionment "does not create an artificial legal distinction among types of firms, and whether multinational entities are organized as subsidiaries, branches, or hybrid entities. Nor does [it] rely on an artificial distinction between [multinational firms] whose parent is incorporated in the United States and [those] whose parent is incorporated elsewhere." Avi-Yonah & Clausing, *supra* note 56, at 14.

69. *Id*. at 16 (that "[T]here would be no need to allocate income and expenses among countries,

In addition, formulary apportionment would allow higher-tax nations like the United States to either reduce tax rates or, if the rates were left unchanged, increase tax revenue.[70] Governments would also likely save money on enforcement costs.[71]

C. Would Formulary Apportionment Really Solve the Problem?

Assuming formulary apportionment could overcome any implementation hurdles, it is unlikely that it would end tax avoidance schemes. Businesses could still attempt to lower their tax burden by "playing" whichever formula is chosen. For example, if either payroll or the number of employees are one of the factors, businesses could use independent contractors in high-tax jurisdictions or outsource work in high-tax jurisdictions to other companies.[72] Similar methods could be used to avoid owning property, if that is a used as a factor.[73] Intellectual property presents a special problem; as its value is often subjective, it is easy to relocate, and it "account[s] for approximately 70% of the value of the top 150 U.S. companies."[74] Increasing the weight of sales as a factor could counteract some of the difficulties presented by intellectual property,[75] but doing so would require one to overcome the challenge of determining how sales will be allocated to a specific county.

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resulting in [a] far lighter compliance burden for firms.").

70. *Id*. at 19–20.

71. "The current [transfer pricing] regime consumes a disproportionate share of both IRS and private sector resources." *Id*. at 16.

72. Roin, *supra* note 1, at 204–05. A hypothetical example of such a scheme might involve:

> Corporation Y hiring a third party (Corporation X) to perform manufacturing services in Country A using the taxpayer's raw material and intellectual property, including manufacturing know-how . . . . Corporation Y [thus] has no employees in A. It may derive a great deal of income from the manufacturing activity, however, by virtue of playing the role of financier, insurer of business risks, and, of course, provider of manufacturing know-how and the like. U.S. taxpayers have succeeded in finding "contract manufacturers," as Corporation X's are called, willing to play their roles for very small markups over cost, leaving Corporation Y with the lion's share of the resulting profits. Meanwhile, Corporation Y does not have a large staff to carry out its lucrative tasks, and can often locate that staff in a small tax haven country.

Id. at 205–06. It may be difficult to distinguish legitimate behavior of this kind from tax-avoidance motivated behavior. "For example, some companies maintain in-house legal staffs, while others use law firms. Some carry out their own manufacturing operations, while others contract with organizations specializing in such operations." *Id*. at 205.

73. "[F]acilities utilized by a third-party service provider such as a contract manufacturer would not be imputed back to the contracting party." *Id*. at 206.

74. *Id*.

75. *Id*. ("[T]he exclusion of intangible property from the property factor is probably less distortionary than it first appears because other factors serve as an adequate proxy for such property. In particular, overweighting of the sales factor may do a reasonably good job of apportioning the income

Generally, "sales of tangible property are attributed to the state to which such property is shipped or in which it is delivered."[76] Businesses can frustrate such a system, however, by setting up "strawmen" to complete sales in low-tax jurisdictions.[77] Some jurisdictions have tried to fight this practice by adopting tests that apportion a sale to the place where the good ends up after all transportation is completed, but such a standard generally "introduc[es] 'time-consuming and burdensome complexities.'"[78] Sales of services involving international businesses are also often difficult to assign to a specific location.[79]

In summary, the practical problems associated with implementing formulary apportionment have prevented its adoption. The challenges have thus far outweighed the foreseeably attainable benefits of minimizing transfer pricing, which as discussed, may be obtained in part with other tax avoidance procedures. Until a global tax system is adopted, nations will benefit by improving their ability to detect transfer pricing and vigorously collecting the taxes due on income fairly attributable to their jurisdiction.

IV. DETERRING TRANSFER PRICING BY MODIFYING NATIONAL TAX REGIMES: THE UNITED STATES LAWS AS AN EXAMPLE

A. Influencing Taxpayer Behavior

A taxpayer's willingness to engage in transactions which are neither clearly legal nor illegal depends on (1) the business's *ex ante* assessment of its probabilities of being audited; (2) the probability that, if audited, the audit will find the business's tax position is illegal; and (3) the magnitude of the penalties which would be imposed after an unfavorable audit result.[80] Generally, taxpayers do not know their probability of being

derived from those intellectual property rights generating benefits in the country of use or purchase, such as patents, copyrights, and marketing intangibles.").

76. *Id*. at 207.

77. Black's Law Dictionary defines a strawman as "[a] third party used in some transactions as a temporary transferee to allow the principal parties to accomplish something that is otherwise impermissible." BLACK'S LAW DICTIONARY (9th ed. 2009).

78. Roin, *supra* note 1, at 207–08.

79. *See id.* at 208–09. One academic noted:

> To a very large extent, the place-of-service test merely replicates the payroll factor and often results in little or no allocation to the market state . . . . One could look to the address of the purchaser, but as is the case with tangible goods, there is no guarantee that the immediate purchaser is anything other than a middleman for some other, ultimate user.

Id.

80. *See* Kyle D. Logue, *Optimal Tax Compliance and Penalties When the Law is Uncertain*, 27 VA. TAX REV. 241, 245 (2007).

audited because the IRS keeps secret the details of how it selects which taxpayers to audit.[81] It is also difficult for businesses to predict the probability that a tax position will be found illegal, for if these predictions were easy, then the transaction would be clearly legal or illegal, based on the prediction. Although it is difficult to accurately predict the probability that the IRS will deem a tax position illegal, a taxpayer can predict quite accurately any penalties that may apply.

Under the U.S. tax code, taxpayers who understate their tax liability are generally subject to a twenty-percent penalty on the portion the taxpayer failed to pay.[82] In cases involving fraudulent underpayment of tax, the penalties more than triple,[83] but this Note assumes that taxpayers are attempting to reduce their tax burden legally. The difference in the penalties shows that Congress understands that uncertainty in the tax laws might cause a taxpayer to underpay without having any intent to defraud the IRS. Were Congress indifferent to the reason the tax was not paid, the penalties would be the same. With the current penalty structure, however, it appears that Congress is trying to achieve a balance between punishing taxpayers and encouraging them to take more aggressive tax positions.

In theory, Congress could mathematically determine the optimal penalty to deter the underpayment of tax. This mathematical determination is referred to as the "Bentham-Becker penalty [and] is calculated by dividing the harm caused by the probability of detection."[84] The harm in

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81. Sarah B. Lawsky, *Probably? Understanding Tax Law's Uncertainty*, 157 U. PA. L. REV. 1017, 1070–71 (2009). There are some techniques, however, a taxpayer could use to get a better idea of the probability of an audit. "The IRS scores individual returns using its Discriminant Index Function (DIF). Any return that scores above a certain numerical threshold is reviewed 'by hand'—that is, by an individual human auditor who decides, based on her review of the return, whether the taxpayer will be audited." *Id*. at 1068–69. With this knowledge:

> [i]n theory . . . taxpayers could figure out a fairly good approximation of the Discriminant Index Function by pooling years of their tax return information and audits and running a regression analysis to figure out how the IRS was selecting returns to audit—that is, what items on a tax return increased chances of an audit, in what combination, and by how much.

Id. at 1070.

82. I.R.C. § 6662(a) (2006).

83. I.R.C. § 6663(a) (2006) (emphasis added) ("If any part of any underpayment of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 75 percent of the portion of the underpayment which is attributable to fraud.").

84. Logue, *supra* note 80, at 266.

> The theory is that such a penalty makes the expected value of the fine equal the harm. Thus in general, so long as (1) the ex post adjudicator can accurately determine both the ex ante probability of detection and the amount of the harm . . . (2) taxpayers or their advisors are aware of this fact, and (3) taxpayers have sufficient assets at risk to care about [a] large ex post penalty, then the use of such an ex post penalty regime can create the proper ex ante tax

this context is the underpayment amount of the tax. The probability of detection is the chance that a taxpayer would be both (1) selected for an audit, and (2) found to have taken an incorrect tax position. A mathematically optimal penalty would cause a taxpayer to act as if the probability of detection were equal to one.[85] Since the actual probability of detection is quite small,[86] any such penalty would need to be quite large to produce the desired counter-incentive. Therein lies the problem. If the underpayment of tax is $100 and there is a 1% probability of detection, then the theoretically appropriate fine is $10,000.[87] Although mathematically correct, such a large fine is unlikely to be politically and practically feasible.[88] Thus, although Congress can, and does, use monetary penalties to deter behavior, it is limited in the extent to which it can use them to achieve the desired effect.

B. Risk Versus Uncertainty

The remaining avenue through which to affect taxpayer behavior is to alter the probability of detection. It is not the actual probability of detection that counts in this regard, but the taxpayer's subjective *ex ante*

> compliance incentives. Indeed, under such a regime, people should behave as if the probability of detection were equal to one and the fine equaled the harm.

Id. at 266–67.

85. *Id*.

86. *Id.* at 264–65.

> According to the most recent Service statistics, the 2005 audit rates were as follows: all individuals (0.9%); individuals with under $25,000 of income (1.5%); individuals with under $100,000 of income (0.8%); corporations with assets over $10 million (20%); corporations with assets over $250 million (44%); corporations with assets under $10 million (0.8%) . . . . Based on research from data from earlier years, it appears that, of those taxpayers who are audited, only a small percentage (as low as 4%) are actually penalized . . . . [A]udit rates for individuals are much higher for certain types of errors, such as omitting income that is reported on information returns.

Id. at 264–65 n.47 (citations omitted).

87. *Id*. at 266.

88. The public would likely consider the fine to be disproportionate to the harm. *Id.* at 268. Calculating penalties in this manner might also be considered inequitable because it would give greater punishment to less aggressive tax positions and lesser punishment to more aggressive tax positions. The IRS naturally focuses more on aggressive tax positions, but this increases the likelihood of detection, which, in theory, means that the penalty does not need to be as high. Conversely, since the IRS places less focus on less aggressive tax positions, thereby lowering the probability of detection, were one of them to nevertheless be found illegal, the theoretically appropriate penalty would have to be quite high. *Id*. at 268–69. An additional complication is that "a rational taxpayer . . . would ignore the threat of any ex post fine that exceeds the amount of her assets that are available to satisfy a tax judgment. This fact . . . limits the ability of large ex post fines to produce optimal ex ante compliance incentives." *Id*. at 269.

assessment of its *ex post* probability of detection.[89] This assessment is not a pure calculation of risk, but rather it is a guess of the likelihood that a possible future event will actually come to pass.[90]

There is an important difference between purely calculating risk and making a guess in an attempt to make something certain that is actually uncertain. Understanding this difference is important for recognizing how one can influence taxpayer behavior in this context. Risk refers to a known probability of occurrence which, given enough repetitions of an event, will eventually emerge.[91] A guess in the face of uncertainty operates differently. It is not a statement regarding a trend that will emerge, but rather a "reflect[ion of] the strength of the speaker's belief that the event will happen . . . ."[92] Since taxpayers' beliefs, as opposed to personal knowledge or calculations, are the basis for their decisions, it is possible to use their beliefs, even if incorrect, as a tool to modify their behavior. The degree of uncertainty itself may also be used to work a change in taxpayer behavior. "If, as empirical work suggests, some taxpayers have an aversion to uncertainty, the uncertainty associated with whether certain questionable transactions are permitted . . . may itself reduce the number of taxpayers who engage in those transactions."[93]

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89. Lawsky, *supra* note 81, at 1044.

90. *See id*. at 1034–35, 1042–43.

91. "This sort of interpretation of a statement of probability . . . is a frequentist interpretation. In other words, a frequentist interpretation of the statement 'The probability of the event is X%' is 'Over the long run, the ratio of occurrences to total events will converge on X%.'" *Id*. at 1027.

92. *Id*. at 1029. Lawsky articulated:

> Someone might say during football season, "The Giants have a 75% chance of winning their next game." . . . Does this person mean that, over the long run, the Giants will win 75% of their games—that their winning percentage over time will converge on 75%? That does not seem right. Maybe next year the Giants will have a terrible team, and for the next twenty years after that they will win only one game a season . . . . Perhaps, then, the person means that the Giants have won three out of four games "just like this one." What does it mean, though, for a game to be "just like this one"? This question raises two related problems. First, this is a nonrepeatable event: the Giants playing next week's opponents under these precise circumstances will happen only once. Second, we have a reference class problem: What group of games should we look at to determine how many times the event "Giants win" occurs? . . . Away games? Games against this opponent? Away games against this opponent? . . . As we make the description of the reference class more specific, we are in some ways gaining information . . . . On the other hand, we are also narrowing the class until we have no other games to which to compare this game, because this particular game is a nonrepeatable event.

Id. at 1027–28. Likewise, a taxpayer would face a similar problem in trying to determine the "probability of detection," as it is used in the tax context.

93. *Id.* at 1046.

C. Using Uncertainty to Decrease Transfer Pricing Abuse

Given the behavioral characteristics of people facing uncertainty, an optimal change to the transfer pricing tax laws would (1) take advantage of a commonly held belief, (2) increase uncertainty, and yet (3) not diminish fact-finding accuracy. Stripping the U.S. Tax Court of its jurisdiction in transfer pricing cases and forcing the disputes into Article III courts would have this effect. The possibility of transfer pricing cases going to a jury would significantly alter multinational companies' assessment of such cases.

First, this change would take advantage of the general perception that juries are less predictable in their decisions than judges.[94] Juries are perceived, among other things, to be led astray easily, unable to understand or follow complex trials, and unable to understand a judge's instructions on the law and how facts should be applied to that law.[95] Judges, on the other hand, are seen as "better educated, more sophisticated, and less susceptible to attorney suasion."[96] Companies would likely perceive the possibility of a jury deciding a fact-intensive transfer pricing case as increasing the uncertainty of the decision on legality greater than the uncertainty when the judge acts as the fact-finder.

Many studies have been conducted on jury accuracy, and these studies have generally found that juries are not less accurate than judges.[97] A study conducted through the University of Chicago found that judges agreed with a jury's assessment of liability more than seventy-five percent of the time, and the times they disagreed were evenly split between plaintiffs and defendants.[98] Even when the judges disagreed with a jury's decision, they usually agreed that the jury's decision was reasonable.[99] In addition, several studies refute the perception that juries are easily confused or fooled by expert witnesses[100] or are likely uneducated.[101]

94. *See* Neil Vidmar, *The Performance of the American Civil Jury: An Empirical Perspective*, 40 ARIZ. L. REV. 849, 849–50 (1998).

95. *See id*.

96. *Id*. at 850.

97. *See* HARRY KALVEN JR. & HANS ZEISEL, THE AMERICAN JURY 63–65 (1966).

98. *See id*.

99. *See id.* at 54–57, 104–08; Vidmar, *supra* note 94, at 849–50.

100. Vidmar, *supra* note 94, at 863–64 ("[S]tudies also lend little support to the claim of juror gullibility.").

101. "A review of data from the 2000 United States Census indicates that there is a sizeable percentage of highly educated people in at least twenty of the nation's most populous and most litigious counties." Richard C. Waites & David A. Giles, *Are Jurors Equipped to Decide the Outcome of Complex Cases?*, 29 AM. J. TRIAL ADVOC. 19, 29 (2005). Of course, if the highly educated people

Thus, by forcing transfer pricing cases into Article III courts where a jury trial is possible, the system can maintain accuracy of its decisions while gaining a degree of perceived unpredictability. This perceived unpredictability will likely lead to a reduction in the aggressive use of transfer pricing for tax avoidance. Corporate decision-makers will feel there is a greater need to avoid risky behavior because of the perceived higher degree of uncertainty associated with the possibility of later facing a jury. Moreover, removing transfer pricing cases from the U.S. Tax Court's jurisdiction also creates a financial incentive to avoid aggressive transfer pricing schemes, and perhaps the concomitant increased risk of IRS scrutiny, because businesses would not be able to delay paying the tax at issue. Forcing businesses to pay first and litigate later would make them consider the time value of the money in question, which may be significant given the length of time needed for a full jury trial. This approach may help deter aggressive use of transfer pricing schemes.

V. CONCLUSION

Tax avoidance by multinational enterprises is serious and growing problem. While the goal of anti-tax-avoidance legislation is relatively simple to understand and stated in broad terms, actually implementing a system to carry out these goals has proven extremely difficult. The adoption of a global tax system to overcome the difficulties associated with each country trying to resolve the issue independently does not appear to be a viable solution. In the United States, businesses are able to choose a forum for tax disputes where they do not have to pay the disputed tax up front and are guaranteed that they will not face a jury. This system supports multinational enterprises' willingness to engage in aggressive transfer pricing schemes. Stripping the U.S. Tax Court of its jurisdiction in transfer pricing cases would force businesses into a forum where the disputed tax must be paid up front and the government would be able to insist that a jury serve as the fact-finder. This change would reverse the

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are not the people serving on juries, then their presence in the community at large would not be of any help to accuracy in the courtroom. Thus,

> [b]ecause of previous legal complaints about the demographics of a given jury pool, federal and state court clerks are sensitive to the issue. They have instituted enhancements in their jury selection procedures that should result in a healthy combination of jurors of all intellectual and educational levels.

Id. at 30. *But see id*. at 26 ("One example of the confusion being experienced by federal courts is the question about whether there should be a 'complexity exception' that would carve out complex cases that would otherwise be subject to the requirements of a jury trial under the Seventh Amendment.").

financial incentive built into the current system in the United States and decrease businesses' willingness to use aggressive transfer pricing tactics to shift income to lower-tax jurisdictions. While obviously not a complete solution to the underlying problem, stripping the U.S. Tax Court of jurisdiction in transfer pricing cases would be a small step in the right direction.

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