PROPOSED INTERNATIONAL LEGAL REFORMS FOR REDUCING TRANSFER PRICING MANIPULATION OF INTELLECTUAL PROPERTY

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I. INTRODUCTION

Most Multinational Enterprise Groups (MNE Groups)[1] aggressively engage in global strategic tax planning, resulting in some "abusive tax avoidance."[2] A major type of abusive tax avoidance is manipulation of transfer prices, which allows MNE Groups to shift income from higher-tax countries to lower-tax countries. Transfer prices are the charges for products, services, or technology transferred within an MNE Group.[3] An MNE Group consists of multiple Multinational Enterprises (MNEs), which are related corporations or similar entities operating in more than one country. Thus, any related-party transaction within an MNE Group involves transfer prices.[4] World trade is dominated by related-party transac-

1. A multinational enterprise (MNE) is a company that is part of a "MNE Group." An MNE Group consists of related corporations or similar entities operating in more than one country. Organisation for Economic Co-operation & Development (OECD), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at G-6 (2001) [hereinafter OECD Guidelines].

2. "Abusive tax avoidance" transactions usually have most of the following characteristics: They exist among related parties in transactions that are difficult to detect, involve highly complex fact patterns and large dollar amounts, and are aided by sophisticated tax professionals who are well-versed in finance and taxation. *See* Charles P. Rettig, IRS Enforcement Strategic Options for Taxpayers 3-4 (Dec. 7, 2005) (Working Paper, 2005 Tax Controversies Conference, Hawaii Society of CPAs) (on file with the New York University Journal of International Law and Politics).

3. Most MNE Groups are either from the United States and operate in one of the thirty countries comprising the Organisation for Economic Co-operation and Development or from OECD countries and operating either in the United States or in other OECD countries. Among the top 20 MNEs, seven have their home in the United States and the other thirteen are in other OECD countries: five are based in Japan, and there are four each in the United Kingdom and Germany. *See* MONICA BOOS, INTERNATIONAL TRANSFER PRICING: THE VALUATION OF INTANGIBLE ASSETS 5 (2003).

4. Transfer pricing is the act of determining the prices to use for transactions between related parties, such as a parent corporation and one of its subsidiaries. Transfer pricing is not an exact science, but requires considered professional judgment in its application by both MNEs and government tax administrators. *See* OECD, *Comparability: Public Invitation to Comment On A Series Of Draft Issues Notes*, at 23, OECD Doc. CTPA/CFA (2006) 31 (May

tions,[5] and related-party transactions within MNE Groups worldwide constitute over half of the total trade conducted by these MNEs.[6] This means that transfer pricing plays a significant role in world trade.

10, 2006), http://www.oecd.org/dataoecd/59/38/36651642.pdf [hereinafter OECD, *Comparability*].

5. Related-party transactions are estimated to represent between forty and sixty percent of world trade. STAFF OF JOINT COMM. ON TAXATION, OVERVIEW OF PRESENT-LAW RULES AND ECONOMIC ISSUES IN INTERNATIONAL TAXATION, at JCX-13-99 (Mar. 9, 1999), *available at* http://www.house.gov/jct/x-13-99.htm (related-party trade is forty percent of U.S. imports and exports); Robert Guy Matthews & Jeanne Whalen, *Glaxo Will Settle A U.S. Tax Case for $3.4 Billion*, WALL ST. J., Sept. 12, 2006, at A19 (related-party trade is sixty percent of world trade).

The definition of "related parties" depends on the country and the precise legal provisions. For example, Indonesia defines related parties as individuals and entities with whom the taxpayer has a "special relationship," a twenty-five percent or more ownership, or de facto control. *See Indonesia: Authority to Start Requiring Companies Disclose Their Related-Party Transactions*, 11 BNA TAX MGMT. TRANSFER PRICING REP. 718 (2002). In contrast, Peru extends the definition of "related parties" beyond affiliates to include transactions with parties in tax havens, an exclusive supplier to the taxpayer, an exclusive client of the taxpayer, or a party highly dependent on the taxpayer. *See Peru: Peru Adopts Legislation to Require Information Report, Transfer Pricing Study*, 12 BNA TAX MGMT. TRANSFER PRICING REP. 968 (2004).

6. The world's 200 largest MNE Groups represent over one-fourth of the world's GDP. *See* Sarah Anderson & John Cavanagh, *Corporate Empires*, MULTINAT'L MONITOR, Dec. 1996, *available at* http://multinationalmonitor.org/hyper/mm1296.08.html.

For example, assume that Glaxo-Parent-Co. has two subsidiaries: Glaxo-Canada and Glaxo-Ireland. Assume profits in Glaxo-Canada are subject to a thirty-five percent corporate tax rate, while Glaxo-Ireland's profits are subject to just a ten percent corporate tax. Glaxo-Parent-Co. directs its subsidiaries to help Glaxo-Parent-Co. maximize its after-tax profits by all legal means, including the transfer prices within the Glaxo MNE-Group. *Cf.* GLAXOSMITHKLINE, 2005 ANNUAL REPORT 98 (2006), *available at* http://www.gsk.com/investors/reps05/annual-report-2005.pdf [hereinafter GSK ANNUAL REPORT] ("Profits arising in operations in Singapore, Puerto Rico, Ireland, and Belgium are accorded special status and are taxed at reduced rates.").

Assume that Glaxo-Canada develops a patent for a new drug to treat ulcers. Assume the patent costs Glaxo-Canada $2 to create. Glaxo is willing to sell its patent's international licensing rights to the related MNE Glaxo-Ireland for $2. Thus, Glaxo-Canada's $2 of revenues and $2 of expenses results in no taxable income and no Canadian corporate taxes.

Now assume that a third party competitor is willing to pay $10 to purchase Glaxo-Ireland's patent. However, Glaxo-Canada is not willing to sell the patent because other new drugs may rely on this and other patents.

Transfer prices are important for MNE Groups for both managerial and tax reasons.[7] For managerial purposes, transfer prices are necessary to allocate revenues and costs efficiently within a large organization. An MNE Group could also strategically use transfer pricing to ensure a proper allocation of the MNE Group's scarce resources.[8] Additionally, transfer prices can serve as a monitoring tool to evaluate the performance of MNEs within an MNE Group.[9] Thus, appropriate transfer prices can motivate managers to operate their divisions or subsidiaries as productively as possible and promote the vitality of the larger organization.

In a survey of the world's largest businesses, appropriate transfer pricing has consistently ranked as the most pressing

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Based on data from other MNEs, the Canadian government believes that generally 90% of drug sales arise from international sales. Thus, if an arm's length transaction had occurred with an independent third party, Glaxo-Canada should have received $9 for the sale of the international patent rights ($10 times 90% international value). If Canada then requires a transfer pricing adjustment so that Glaxo-Canada is deemed to have revenues of $9, while continuing to have expenses of $2, a $7 profit results. Canada could then collect more than $2 of tax revenues from Glaxo-Canada ($7 profit times 35% corporate tax rate).

In the example, Glaxo-Parent-Co is not happy that the Canadian government has imposed a transfer pricing adjustment. Now that the Glaxo-Canada subsidiary has some profits, it must pay the relatively high Canadian taxes. Furthermore, Glaxo-Canada will have less money to transfer back to Glaxo-Parent-Co. Instead, a strong preference exists from Glaxo-Parent-Co. to shift subsidiary profits to Glaxo-Ireland, because the corporate taxes are much lower in Ireland. A lower total worldwide tax expense from the subsidiaries also helps the country in which Glaxo-Parent-Co is located because the company has a larger tax base which enables the country to more easily raise tax revenues or reduce tax rates.

7. Most MNE parent corporations claim to use a single set of transfer prices for all purposes. *See* ERNST & YOUNG, TRANSFER PRICING 2003 GLOBAL SURVEY 17 [hereinafter ERNST & YOUNG, TRANSFER PRICING 2003]. However, two different transfer prices are used by a growing number of MNE Groups. *See* Chongwoo Choe & Charles Hyde, Multinational Transfer Pricing, Tax Arbitrage and the Arm's Length Principle 1 (Sept. 24, 2004) (working paper, available at http://ssrn.com/abstract=600881) (describing how some companies use one transfer price for internal managerial purposes and another for tax purposes).

8. *See generally* Weston Anson & Chaitali Ahya, *How to Make Transfer Pricing Work for IP and Intangible Assets,* INT'L TAX REV., Oct. 2004, at 14.

9. *See* FREDERICK D.S. CHOI & GERHARD G. MUELLER, INTERNATIONAL ACCOUNTING 518, 519 (2d ed. 1992).

international tax issue each year over the past decade.[10] Even after considering legal restrictions on transfer pricing, tax advisers believe that "a savvy transfer pricing strategy could potentially shave off up to 15% of [an MNE Group's] tax liability."[11]

Particularly when an MNE Group tax manager is motivated in the creation of higher after-tax rates of return and thus in tax planning by bonus and stock option compensation structures, international business transactions that raise serious legal or ethical concerns are likely to appear.[12]

Tax strategies[13] that involve manipulation of transfer prices to reduce MNE Groups' total tax liabilities may lead to abusive tax avoidance. The use of inflated and undervalued transfer prices enabled MNEs to underpay an estimated $53

10. In 2003, 68% of parent MNE respondents and ninety-three percent of subsidiary MNE respondents identified transfer pricing as the most important international tax issue. *See* ERNST & YOUNG, TRANFER PRICING 2003, *supra* note 7, at 4. In Europe, however, the increasing complexity of legal developments and compliance with legal tax requirements has made transfer pricing only the second biggest tax concern for MNE tax directors. *See generally* Sed Crest, *Tax Executives Face New Boss in Europe: Sed Crest Discovers Who Rules the Tax Roost in Europe and How Tax Directors are Reacting*, INT'L TAX REV., June 2005, at 13 (reporting that 30% of respondents to a European tax survey say that "keeping abreast of developments and growing compliance complexity" is their biggest challenge, compared with 10% who say that transfer pricing is their biggest challenge).

11. Russ O'Haver et al., *Improving Deals with Transfer Pricing*, 5 INTERCHANGE 4 (Dec. 2004). MNE Groups can minimize their taxes through three types of activities: tactical (profit shifting activities), operational (financial restructuring), and tax planning (MNE Group structure reorganization). BOOS, *supra* note 3, at 11.

12. A major type of international business transaction raising concern is a "corporate inversion," also known as a "flip transaction" or "corporate expatriation." This transaction involves a reorganization in which the parent corporation MNE moves outside of the United States to a foreign country. For example, an MNE Group will move its MNE parent corporation to a country where it has few business operations and low taxes, such as Bermuda. *See* Elizabeth Chorvat, *You Can't Take It with You: Behavioral Finance and Corporate Expatriation*, 37 U.C. DAVIS L. REV. 453, 455 (2003). *See generally* Press Release, Dep't of the Treasury, Office of Tax Policy, Corporate Inversion Transactions: Tax Policy Implications (May 2002), *available at* http://www.treas.gov/press/releases/docs/inversion.pdf.

13. *See generally* Thomas C. Pearson, *Preparing Multinational Companies for Transfer Pricing Audits of Intangibles*, 2 BYU INT'L L. & MGMT. REV. 159 (2006).

billion in U.S. taxes in 2001.[14] Many governments are concerned that MNE Groups manipulate transfer prices to decrease their taxable income in "high tax rate countries"[15] by increasing their taxable income in "low tax rate countries."[16] Recently, the U.S. Internal Revenue Service (IRS) settled a transfer pricing dispute with MNE Group GlaxoSmithKline. The record high $3.4 billion settlement illustrates how MNE Groups use transfer pricing manipulation of IP values to reduce taxes.[17]

Another tax avoidance problem is MNE Groups' use of "tax havens."[18] As MNEs increasingly function as a seamless

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14. *See* Simon J. Pak & John S. Zadnowicz, *U.S. Trade with the World: An Estimate of 2001 Lost U.S. Federal Income Tax Revenues Due to Over-Invoiced Imports and Under-Invoiced Exports* 2-6 (2002), *available at* http://dorgan.senate.gov/newsroom/extras/pak-zdan.pdf; *Compliance: U.S. Lost $53 Billion in Tax Revenues From Improper Pricing in 2001, Study Says*, 11 BNA TAX MGMT. TRANSFER PRICING REP. 642 (2002).

15. Within an MNE Group, imports to an MNE in a higher-tax country may be deliberately overcharged in order to substantially reduce the MNE's taxable income and corporate taxes and consequently improve the MNE Groups' total after-tax profits. *See, e.g.*, Eric J. Bartlesman & Roel M. W. J. Beetsma, *Why Pay More?: Corporate Tax Avoidance Through Transfer Pricing in OECD Countries*, 87 J. OF PUB. ECON. 2225 (2003); *Russia: Russia Boosts Pricing Scrutiny Says $1 Billion Lost to Improper Pricing*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 363 (2004); *see also* Tommy Staahl Gabrielsen & Guttorm Schjelderup, *Transfer Pricing and Ownership Structure*, 101 SCAND. J. OF ECON. 673, 674 (1999) (explaining that the Czech Minister of Trade and Industry openly accused the Volkswagen MNE Group of transferring profits to other parts of its MNE Group outside of the Czech Republic).

16. The profits of foreign subsidiaries of U.S. MNEs in 18 tax havens rose dramatically from $88 billion in 1999 to $149 billion in 2002. Those 18 tax havens represented 58% of the foreign profits of MNEs, an amount grossly exceeding the business activities conducted in those countries. *See* Martin A. Sullivan, *Economic Analysis: Data Show U.S. Companies Shifting Profits to Tax Havens*, 35 TAX NOTES INT'L 1035, 1035 (2004).

17. *See* Press Release, Dep't of the Treasury, Internal Revenue Service (IRS), IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute (Sept. 11, 2006), *available at* http://www.irs.gov/newsroom/article/0,,id=162359,00.html. *See generally* David S. Hilzenrath, *Glaxo To Pay IRS $3.4 Billion*, WASH. POST, Sept. 12, 2006, at D1.

18. Tax havens are sometimes referred to as "Offshore Financial Centers." *See generally* Prem Sikka, *The Role of Offshore Financial Centres in Globalization*, 27 ACCT. F. 365 (2003). Tax haven jurisdictions generally provide two fundamental advantages for business: (1) little or no tax on investment income derived in the tax haven and (2) financial secrecy laws to attract investment from residents in other countries. Outside the OECD, only five of the forty-one countries or jurisdictions identified as tax havens still refuse

part of larger MNE Groups, the MNE Groups tend to shift income or income-producing assets to their MNEs in tax havens.[19] Both types of tax avoidance affect where in the world MNE Groups' income is taxed[20] and the potential tax revenues collected by individual countries.[21] As a result, these tax avoidance problems unfairly drain significant tax revenue from the governments of many countries.[22]

Among the transfer pricing transactions of MNE Groups, intellectual property (IP)-related transfer prices are the most significant and susceptible to manipulation. This is a result of IP's high value and mobility and the complexity of IP-related issues. IP carries tremendous value because it often produces or has the potential to produce enormous amounts of royalties. Given that IP is an intangible[23] paper asset without physi-

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to cooperate with the OECD. *See* Cordia Scott, *OECD Unveils Progress Report on Harmful Tax Regimes*, 33 TAX NOTES INT'L 1151, 1153 (2004).

19. MNEs operating in tax havens acquire a significant financial advantage over competitors located in OECD countries.

20. In the industrialized world, transfer pricing is the leading international tax issue. *See* CYM H. LOWELL ET AL., U.S. INTERNATIONAL TRANSFER PRICING ¶ 11.03(3) & n.186 (2005). Transfer pricing is also the most significant tax issue in many developing economies, such as China. *See* Khoonming Ho & Jean Li, *China*, WORLD TAX 2005, at 116, 122 (2005).

21. For example, in Australia the value of related-party business transactions in a year was estimated at $76 billion, excluding cross-border related-party loans. *See* Jim Killaly, Australian Taxation Office, Presentation at the Transnational Crime Conference: Transfer Pricing Compliance Issues and Insights in the Context of Global Profit Allocation 2 (Mar. 9–10, 2000), *available at* http://www.aic.gov.au/conferences/transnational/killaly.pdf.

22. For example, Enron used off-shore MNEs to create "opaque corporate structures" which wiped out its corporate income taxes in India, Hungary, and (for one year) the United States. *See* Steven Filling & Prem Sikka, *Taxing the Boundaries of Corporate Social Reporting*, 33 PUB. INT. 21, 22 (2004), *available at* http://aaahq.org/PublicInterest/newsletr/Fall04/fall04.pdf.

23. "Intangibles" are property lacking physical substance and existing merely on paper. BLACK'S LAW DICTIONARY 811 (7th ed. 1999). Tax law in the United States considers patents as common types of intangibles. Intangibles are often defined slightly differently for different purposes, even in the tax law. For example, in the United States, intangibles are defined differently for purposes of Internal Revenue Code (I.R.C.) § 197 (amortization over 15 years) than they are for § 482 (transfer pricing). *See* Internal Revenue Code, 26 U.S.C. §§ 197 (2004) (deductions for amortizable intangibles), 482 (1986) (transfer of intangible property), 936(h)(3) (2007) (tax treatment of intangible property income). To provide greater clarity for non-tax professionals, I have chosen to refer to "IP" rather than intangibles in this Note.

cal presence, it is easily transferable from one country to another. IP-related financial issues exist in commercial practices, valuation, and accounting as well as in attribution of income for tax purposes. These intricate financial issues are often complex and in a state of flux. Consequently, tax avoidance through transfer pricing manipulation of IP is a growing problem.[24]

For example, MNE Groups often attribute research and development (R&D) expenses to higher-tax countries which provide immediate expensing of these R&D costs.[25] However, in reality, the R&D costs of producing IP may be widely dispersed among related entities. Subsequent transfer prices charged through royalty fees to affiliate MNEs often fail to adequately adjust for the real risk premium assumed in the original development of the IP. In other situations, to shift deductions to a higher-tax country, the MNE Group might impose higher transfer prices on a related MNE operating in a lower-tax country. This shift is made possible by service charges, royalties paid to the owner or licensor of the IP, or through "cost-sharing arrangements."[26]

Abusive tax avoidance through transfer pricing manipulation arises more easily in today's complex international business environment.[27] MNE Groups have become more interna-

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24. "82 of the largest and most profitable U.S. companies reported pre-tax profits of $1.1 trillion for the period 2001-2003 but paid no federal income taxes in at least one of those years." Filling & Sikka, *supra* note 22, at 22.

25. *See, e.g.*, 26 U.S.C. § 174(a)(1) (2004).

26. *See* Treas. Reg. § 1.482-7 (as amended in 2004); Prop. Treas. Reg. § 1.482-7, 70 Fed. Reg. 75759 (Dec. 21, 2005). Determining the value of pre-existing intangibles from a sale or license is often an issue. Another issue is if the intangible was made available under a qualified "cost sharing agreement." *See* BOOS, *supra* note 3, at 140. The United States issued 200 pages of new proposed regulations on August 22, 2005 that are "[b]yzantine in their complexity, [but addressed to MNEs] . . . shifting income from self developed intangibles to low-tax countries." Lee A. Sheppard, *Is Apportionment the Formula for Intangible Development*, 108 TAX NOTES TODAY 1093, 1093 (2005).

27. Worldcom provided a classic example of abusive tax avoidance through transfer pricing manipulation. The auditors for Worldcom, KPMG, advised Worldcom that "management foresight" could qualify as IP for placement in an intangible holding company (IHC). "Management foresight" was a previously unheard-of IP asset. However, Worldcom licensed that "foresight" to MNE subsidiaries for royalties, which counted these royalties as tax deductible business expenses. *See* Filling & Sikka, *supra* note 22, at

tional and, correspondingly, more organizationally complicated in the past decade.[28] To achieve business efficiency, many MNE Groups have shifted their organizational structures from country-specific subsidiaries to regional or global operations of various business units.[29] Other changes include realigning management around "products, profitability, [business] alliances, financing and taxation."[30] Global design, production, and marketing have also become commonplace.[31] As

22. The examiner of Worldcom found that KPMG's tax advice represented malpractice and negligence with regard to its tax shelter sales from 1996-2002. *New York; States File Claims in MCI Bankruptcy Case; Transfer Pricing Royalty Program Examined,* 12 BNA TAX MGMT. TRANSFER PRICING REP. 1161 (2004). On June 16, 2005, KPMG apologized for its tax shelter sales. Kara Scannell, *KPMG Apologizes for Tax Shelters: Firm Takes Responsibility for Improper Tax Shelters; U.S. Debates Indictment,* WALL ST. J., June 17, 2005, at A3.

28. *See generally* Gregg D. Lemein, *Transfer Pricing and Related Tax Aspects of Global Supply Chain Restructurings*, 37 TAX NOTES INT'L 715 (2005). Since the late 1990s, several U.S. MNEs have reincorporated in tax havens. *See* Andrew N. Berg, *Focus on the IRS: NYSBA Discusses Corporate Inversions*, 95 TAX NOTES TODAY 1456 (2002). The number of MNE Groups practically doubled in the 1990s, while the number of their foreign MNE subsidiaries quadrupled. *See Corporate Tax: A Taxing Battle*, ECONOMIST, Jan. 29, 2004, at 72.

29. *See generally* Gary D. Sprague, *Application of Transfer Pricing Rules to Branches and Permanent Establishments—Electronic Commerce and Intangibles Aspects*, 10 GEO. MASON L. REV. 971 (2002); OECD, DIRECTORATE FOR SCIENCE, TECHNOLOGY & INDUSTRY, INDUSTRY COMMITTEE, BUSINESS AND INDUSTRIAL POLICY FORUM ON STRUCTURAL FACTORS DRIVING INDUSTRIAL GROWTH: BACKGROUND REPORT (Feb. 29, 2000), *available at* http://www.oecd.org/dataoecd/41/53/1859744.pdf. MNE groups might have regional headquarter operations to perform accounting, treasury, human resources, and administrative functions for a world region. Other changes arise partly from greater use of the Internet and other technologies for efficient business operations, such as adopting an "intellectual asset management system" to help manage IP globally in order to create more value from MNE Groups' IP assets. *See* DENNEMEYER LEADING PRACTICE SERIES, ROI: PROVING THE VALUE OF INTELLECTUAL ASSET MANAGEMENT 2 (2004), *available at* http://www.dennemeyer.com/documents/DEN_ROIProving.pdf; *see also id.* at 2 n.7.

30. Killaly, *supra* note 21, at 2.

31. For example, the MNE Group GlaxoSmithKline may develop a drug in Canada with assistance from employees in its subsidiaries in various other countries, obtain patent rights for the drug throughout the world, manufacture the drug in Puerto Rico, and acquire administrative assistance from the MNE parent company in the United Kingdom, while generating still most of its revenues from sales to consumers in the United States.

a result, many MNE Groups today are "integrated networks."[32] These new dimensions in the organizational structures of MNE Groups have made it more difficult for governments to detect when an MNE Group avoids tax through the manipulation of transfer prices.[33]

Many governments have established regulations to address this growing tax avoidance problem. The recent regulations, however, have not been adequate to combat the sophisticated tax avoidance tactics of MNE Groups.[34] The highly integrated global networks of MNE Groups and the complexity of IP-related issues have also made it more difficult for governments to audit transfer prices among related MNEs within an MNE Group.[35]

Part II of this Note discusses background information on patents and international legal protection for patents. Part III examines the abusive tax avoidance problems that emerge when transfer pricing manipulation of IP occurs. Finally, Part IV proposes a set of international legal reforms to reduce such abusive tax avoidance. These proposed legal reforms are threefold: (1) modifying international treaties on IP registration to incorporate a minimum tax on IP to prevent it from escaping significant taxation; (2) adopting uniform and all-inclusive multiple ownership rules to identify rightful owners of IP for taxation; and (3) applying "formulary apportionment" to allocate income from IP to its owners.

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32. An "integrated network" links people in various locations to focus on a particular task or product. BOOS, *supra* note 3, at 6. Global financial institutions provide examples of commercial activities simultaneously occurring in different countries. This global activity is happening in more businesses, often over the intranet as intra-firm electronic commerce. *Id.* at 7.

33. Recent worldwide reductions of corporate income tax rates help some governments hide the severity of the abusive tax avoidance problem, but effectively fleeces those members of the taxpaying public who pay their fair share of taxes. *See* David R. Hardy, *Assignment of Corporate Opportunities—The Migration of Intangibles*, 100 TAX NOTES TODAY 527, 540-541 (2003). From 1996 to 2003, OECD countries reduced corporate taxes by nearly seven percent. *See Corporate Tax*, *supra* note 28, at 72.

34. *See, e.g.*, *Russia: Russian Officials Move to Seize Yukos Assets After Firm Misses Deadline to Pay Back Taxes*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 264 (2004); *Court to Proceed on $11 Billion Lawsuit Against Yuko for Abusive Transfer Pricing*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 1231 (2005).

35. *See* OECD, Third Meeting of the OECD Forum on Tax Administration: Final Seoul Declaration 3 (Sept. 14–15, 2006), *available at* http://www.oecd.org/dataoecd/38/29/37415572.pdf.

This Note contributes to the vast transfer pricing literature in the professional accounting and tax literature,[36] in law reviews,[37] and in other academic areas.[38]

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36. The professional literature on transfer pricing is more likely to report on a narrow aspect of transfer pricing, such as examining either one particular issue or discussing transfer pricing law in smaller countries. *See, e.g.*, Charles Berry et al., *Arm's-Length Pricing: Some Economic Perspectives*, 54 TAX NOTES TODAY 731 (1992) (focusing on the narrow issue of the arm's length standard).

37. The law review literature on transfer pricing is extensive. The first generation of law review articles from the 1970s addressed the general concepts of transfer pricing arising from early U.S. cases and regulations. *See, e.g.*, Howard LaMont, *Multinational Enterprise, Transfer Pricing, and the 482 Mess*, 14 COLUM J. TRANSN'L L. 383 (1975); Steven A. Linde, *Regulation of Transfer Pricing in Multinational Corporations: An International Perspective*, 10 N.Y.U. J. INT'L L. & POL. 67 (1977).

The second generation of law review articles, beginning in the late 1980s, examined the more sophisticated legal reforms in the United States, including documentation requirements and a penalty structure to enforce transfer pricing. *See, e.g.*, Harlow N. Higinbotham et al., *Effective Application of the Section 482 Transfer Pricing Regulations*, 42 TAX L. REV. 293 (1987); Rom P. Watson, *New Developments in Transfer Pricing Rules*, 17 BROOK. J. INT'L L. 61 (1991).

The third generation of law review articles on transfer pricing started in the 1990s. These articles mirrored the expansion of transfer pricing in various countries, explained specific countries' transfer pricing regimes, and often compared foreign regimes to that of the United States. *See, e.g.*, Seung Steve Choi, *Comparative Analysis of Transfer Pricing Systems in the United States and Korea*, 20 LOY. L.A. INT'L & COMP. L.J. 803 (1998); David Grecian, *Australia's Approach to Transfer Pricing Documentation and Penalties*, 10 GEO. MASON L. REV. 915 (2002); Omar Morales, *Transfer Pricing in Chile: A Comparison of the OECD Guidelines and U.S. Regulations*, 79 U. DET. MERCY L. REV. 415 (2002), Alexandre Tadeu Seguim, *New Transfer Pricing Rules in Brazil*, 19 NW. J. INT'L L. & BUS. 394 (1999).

Since 2000, the fourth generation of transfer pricing law review articles has typically addressed more limited aspects of transfer pricing issues. These articles often have a more global or conceptual perspective and use data from various countries, but they are still highly influenced by trend-setting developments in the United States and the OECD. *See, e.g.*, Robert Ackerman & Elizabeth Chorvat, *Modern Financial Theory and Transfer Pricing*, 10 GEO. MASON L. REV. 637 (2002); Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation*, 21 MICH. J. INT'L LAW 143 (2000).

38. Academic research on transfer pricing began with economic analysis. *See* Jack Hirshleifer, *On the Economics of Transfer Pricing*, 29 J. OF BUS. 172 (1956) (arguing that the best economic price was either the market price or the marginal cost for the division making the product). Other major academic perspectives included in the research literature include accounting,

II. The Complexity of Intellectual Property Issues

This Part explores the extensive challenges created by IP in order to help reveal the full scope of the abusive tax avoidance problem resulting from transfer pricing manipulation by MNE Groups. Part II.A first provides a general overview of the international legal protection afforded to IP and then proceeds to address specific considerations for patents. Part II.B discusses various challenges in taxing IP. The commercial practice of bundling IP together for sale presents a problem for understanding transfer pricing manipulation in this context. Other challenges include wide variance in the valuation of IP, accounting standards that fail to recognize the existence of IP, and the difficulty faced in determining the revenue attributable to various IP for tax purposes.

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behavioral economics, and strategic management. *See, e.g.*, Julie Collins et al., *Transfer Pricing and the Persistent Zero Taxable Income of Foreign-Controlled U.S. Corporations*, 19 J. Am. Tax'n Ass'n. 68 (1997) (examining transfer pricing through accounting research). The behavioral perspective incorporates the human dimension in transfer pricing decisionmaking. *See, e.g.*, Michael Alles & Srikant Datar, *Strategic Transfer Pricing*, 44 Mgmt. Sci. 451 (1998); Steven J. Kachelmeier & Kristy L. Towry, *Negotiated Transfer Pricing: Is Fairness Easier Said Than Done?,* 77 Acc. Rev. 571 (2002).

The types of research used to study transfer pricing have varied. A popular research method uses surveys establishing general trends in the factors affecting transfer pricing. *See, e.g.*, Mohammad F. Al-Eryani et al., *Transfer Pricing Determinants of U.S. Multinationals*, 21 J. Int'l Bus. Stud. 409 (1990) (arguing that legal considerations and financial reporting rules are the most influential factors). Other studies use economic models that help managers evaluate some key factors for transfer pricing decisions. *See, e.g.*, Sabine Böckem & Ulf Schiller, *Transfer Pricing and Hold-Ups in Supply Chains*, 5 German Econ. Rev. 211 (2004); Robert Halperin & Bin Srindihi, *U.S. Income Tax Transfer-Pricing Rules and Resource Allocation: The Case of Decentralized Multinational Firms*, 66 Acc. Rev. 141 (1991). Another type of research is mathematical programming to model interactions among transfer pricing factors. *See, e.g.*, Tim Baldenius et al., *Integrating Managerial and Tax Objectives in Transfer Pricing*, 79 Acc. Rev. 591 (2004). Empirical research helps to determine the behavior of MNE Groups in different countries or regions. *See, e.g.*, Howard A. Shelanski, *Transaction-Level Determinants of Transfer-Pricing Policy: Evidence from the High Technology Sector*, 13 Indus. and Corp. Change 953 (2004); Deborah Swenson, *Tax Reforms and Evidence of Transfer Pricing*, 54 Nat'l Tax J. 7 (2001). For further analysis of transfer pricing research methods, see Robert A. Leitch & Kevin S. Barrett, *Multinational Transfer Pricing: Objectives and Constraints*, 11 J. Acct. Literature 47 (1992).

A. *IP and Patents Registration*

IP arises from intellectual creations and consists of intangible property.[39] This broader category of IP includes such other intangibles as know-how and customer lists. As international business has become more complex and integrated, IP has become immensely important. MNE Groups are sometimes able to generate substantial royalties from an external party through a license of IP. By some estimates, the value of patents and other IP comprise seventy percent of the value of the average MNE Group.[40] IP subject to transfer pricing is generally more broadly defined than traditional IP.[41]

International IP law is formed by the treaties and decisions under the World Trade Organization (WTO)[42] and a specialized agency within the United Nations known as the World Intellectual Property Organization (WIPO).[43] Created through multilateral negotiation, this body of law offers basic legal protections for IP and provides an enforcement mechanism to settle international disputes. The WTO, formed in 1994, embraced the agreement on Trade-Related Aspects of

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39. *See generally* World Intellectual Property Organization (WIPO), About WIPO, What Is Intellectual Property?, http://www.wipo.int/about-ip/en (last visited Jan. 12, 2008). IP is a subset of intangibles, so not all intangibles are considered IP. Germany limits IP to assets having legal existence. In Germany, the legal basis for IP must draw on other legal bases such as the code of commercial law or the income tax code. *See* BOOS, *supra* note 3, at 23 n.103; *cf.* Toshio Aritake, *NTA's Revised Transfer Pricing Guideline Details Intangible Contributions, Cost Sharing*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 1028 (2006) (explaining that Japan defines intangibles to include "a broader universe of employee knowledge networks, corporate management functions, and sales promotion").

40. *See* Paula Jellinghaus, Vice President, International Assets, Inc., Address at Practising Law Institute Seminar NYC on Patent & High Technology Licensing: Developing a Strategy for Evaluation and Valuation (June 1, 2005) (on file with the New York University Journal of International Law and Politics).

41. For example, the U.S. category of intangibles for transfer also includes inventions, formulae, processes, designs, patterns, and know-how. Treas. Reg. § 1.482-4(b)(1) (as amended in 2006).

42. The WTO is a global international organization addressing the rules of trade. *See* Marrakesh Agreement Establishing the World Trade Organization, Apr. 15, 1994, 1867 U.N.T.S. 154 [hereinafter WTO Agreement].

43. WIPO is one of sixteen specialized agencies in the United Nations. *See* Agreement Between the United Nations and World Intellectual Property Organization, U.N.-W.I.P.O., Sept. 27-Dec. 17, 1974, 956 U.N.T.S. 405.

Intellectual Property Rights ("TRIPS Agreement").[44] The TRIPS Agreement covers four broad areas: basic principles of IP protection, standards of protection for IP rights, enforcement of rights, and settlement of IP disputes.[45] In order to belong to the WTO and obtain desirable "normal trade relations" status (previously known as "most favored nation" trading status),[46] countries must agree to the TRIPS Agreement.[47]

WIPO globally promotes the use and protection of IP.[48] WIPO administers fourteen international treaties on IP and six treaties on the global protection of IP.[49] To facilitate implementation of the TRIPS Agreement, the WTO and WIPO have an agreement on cooperation.[50] This WTO/WIPO Cooperation Agreement requires notification of, access to, and translation of national laws and regulations as well as technical cooperation.[51] The WTO and WIPO framework for handling IP

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44. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1993, 33 I.L.M. 81, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments—Results of the Uruguay Round, 33 I.L.M. 1125, 1197 (1994) [hereinafter TRIPS Agreement].

45. WORLD TRADE ORGANIZATION (WTO), UNDERSTANDING THE WTO 40-44 (3d ed. 2005), *available at* http://www.wto.org/english/thewto_e/whatis_e/tif_e/understanding_e.pdf.

46. *See, e.g.*, Trade Expansion Act of 1962, 19 U.S.C. § 1881 (as amended July 22, 1998) (showing that section heading formerly "most favored nation principle" now reads "Normal trade relations").

47. TRIPS Agreement, *supra* note 44, art. 1. The WTO's Council for Trade-Related Aspects of Intellectual Property has responsibility for administering the TRIPS Agreement. *Id.* art. 68.

48. WIPO, About WIPO, What is WIPO?, http://www.wipo.int/about-wipo/en/what_is_wipo.html (last visited Jan. 12, 2008). WIPO also has observer status at the WTO. *See* Agreement Between the World Intellectual Property Organization and the World Trade Organization, Dec. 22, 1995, 35 I.L.M. 754 (1996) [hereinafter WIPO/WTO Agreement]; WTO, International Intergovernmental Organizations Granted Observer Status to WTO Bodies, http://www.wto.org/english/thewto_e/igo_obs_e.htm (last visited Jan. 25, 2008).

49. WIPO also administers four other treaties for a total of twenty-four treaties. WIPO, WIPO-Administered Treaties, http://www.wipo.int/treaties/en (last visited Jan. 25, 2008).

50. WIPO/WTO Agreement, *supra* note 48.

51. *Id.* art. 2(4). For example, WIPO and WTO have an initiative to help developing economies maximize the benefits of IP protection. *See* Press Release, WIPO, WIPO and WTO Launch New Initiative to Help World's Poorest Countries, PR/2001/276 (June 14, 2001), *available at* http://www.wipo.int/edocs/prdocs/en/2001/wipo_pr_2001_276.html.

concerns also provides a framework for handling international transfer pricing disputes over IP.[52]

Patents are granted by governments to assist in the development of new innovative technologies and products.[53] Patents consist of various rights[54] which help provide incentives for costly research, facilitate technology transfer, and catalyze new businesses.[55] Legal protection of patents prevents others from commercially using a patented invention without the patent owner's authorization.[56] Patents are generally protected for twenty years.[57]

International treaties significantly impact patent law.[58] International legal registration of patents is now possible with

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52. However, more international cooperation using the WTO/WIPO framework is needed to impose appropriate taxes on high value IP, particularly for those patents transferred between related parties of an MNE Group.

53. Innovations are evident in areas receiving the most patents. In 2004 the areas with the greatest number of patents were (1) pharmaceuticals and cosmetics, (2) computers and data processing, and (3) organic chemistry. *See* WIPO, THE INTERNATIONAL PATENT SYSTEM IN 2004: YEARLY REVIEW OF THE PCT 12 (2004), *available at* http://www.wipo.int/pct/en [hereinafter WIPO, 2004 PCT REVIEW]

54. A patent provides a temporary monopoly to the patent owner by granting the owner a property right to his invention. The property rights apply within a particular country for a limited term of years. *See, e.g.*, 35 U.S.C. §§ 101, 122(b).

55. *See* OECD Guidelines, *supra* note 1, at VI-4, ¶ 6.8.

56. The importance of patent protection is shown by Canadian MNE Blackberry having agreed to pay $612.5 million to a small U.S. firm to settle patent litigation. *See* Jeffrey Silva, *Patent Reform Gathers Support*, RCR WIRELESS NEWS, May 29, 2006, at 16. For a general business perspective on patents, see Harvey E. Bale, Jr., *Patent Protection and Pharmaceutical Innovation*, 29 N.Y.U. J. INT'L L. & POL. 95 (1997).

57. *See, e.g.*, 35 U.S.C. § 154(a)(2) (duration of patent protection). Patents are protected internationally by TRIPS. *See generally* Laurence R. Helfer, *Regime Shifting: The TRIPS Agreement and New Dynamics of International Intellectual Property Lawmaking*, 29 YALE J. INT'L L. 1 (2004).

58. *See, e.g*, 35 U.S.C. § 367 (2002) (noting that applicants for patents "may request review of the matter by the Director, on compliance with the requirements of and within the time limits specified by the treaty and the Regulations"). *See generally* WIPO, WIPO Guide to Intellectual Property Worldwide, http://www.wipo.int/about-ip/en/ipworldwide/treaties.htm (last visited Jan. 12, 2008) (providing a list of IP treaties administered by WIPO). Modifying international agreements to reduce the length of legal protection for IP—for example, creating shorter renewal periods—might make it easier to collect taxes from IP. Shorter legal protection periods for IP could also help prevent products from price inflation and market manip-

a single international patent filing under the Patent Cooperation Treaty (PCT). The PCT enables patent owners to acquire legal protection simultaneously in more than 125 countries.[59] This worldwide registration system for patents enables countries and patent specialists to more easily identify patents and to legally protect them. Already, more than forty million patents are registered worldwide.[60]

The international patent registration system has several problems, including a substantial backlog of patent applications,[61] making it very difficult to evaluate patent claims with appropriate scrutiny.[62] Part of the overload problem arises from the WTO's PCT, which established a low flat rate structure for international patent fees in order to encourage further innovation while providing funding for the treaty's bureaucracy.[63] This low fee structure has had the undesirable effect of promoting frivolous filings of patent applications. Therefore, patent reform in the fee structure is needed to en-

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ulation during the early years of the IP when other substitutes are nonexistent. IP that does not require legal registration is harder for governments to detect and tax.

59. *See* Patent Cooperation Treaty (PCT), June 19, 1970, 28 U.S.T. 7645, *available at* http://www.wipo.int/treaties/en/registration/pct/index.html. The PCT does not change each country's distinctive patent laws, but provides a cooperative network for international registration of patents, recognized in most countries.

60. United States Patent and Trademark Office (USPTO), General Information Concerning Patents, Library, Search Room Searches and Patent and Trademark Depository Libraries, http://www.uspto.gov/web/offices/pac/general/index.html (last visited Jan. 6, 2008).

61. Each year there is a five percent increase in the number of patent applications filed. *See* EUROPEAN PATENT OFFICE, FACTS AND FIGURES 2007, at 12, *available at* http://documents.epo.org/projects/babylon/eponet.nsf/0/ef7be2c894b208f3c125732f005b9452/$FILE/EPO_FaktenZahlen_en.pdf. The application backlog threatens to make some patents obsolete even before they are issued. Lawrence D. Maloney, *Patent Office Faces Backlog Crisis*, DESIGN NEWS, Jan. 10, 2005, at 25, ¶ 7.

62. *See* Brian Kahin, *Through the Lens of Intangibles: What Patents on Software and Services Reveal About the System*, *in* PATENTS, INNOVATION, AND ECONOMIC PERFORMANCE 209, 211 (OECD ed., 2004).

63. *See* WIPO, REGULATIONS UNDER THE PCT 174, *available at* http://www.wipo.int/pct/en/texts/pdf/pct_regs.pdf (schedule of fees); *see also* Gerald J. Mossinghoff, *Patent Harmonization Through the United Nations: International Progress or Deadlock?*, 86 J. PAT. & TRADEMARK OFF. SOC'Y 5, 8 (2004).

courage patent applications that demonstrate genuine innovation.[64]

The international patent registration system does not appear to fully achieve the underlying policy goal of promoting innovative technology.[65] Instead, MNE Groups use the patent registration system primarily for defensive purposes of blocking technology development by other MNE Groups.[66] Furthermore, the imperfections in the current patent system result in patents that are neither innovative nor deserving of patent rights, diverting unwarranted market power to the patent holder and unjustifiably increasing costs for society.[67]

The international patent registration system has also failed to prevent MNE Groups from engaging in abusive tax avoidance regarding IP. This problem is demonstrated by the extensive movement of the legal ownership of IP during the last decade to "Intangible Holding Companies" (IHCs) in tax-haven countries.[68] As a result of the increasing number of IHCs in tax-haven countries, significant evaporation of the cor-

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64. Mark Lemley, Doug Lichtman & Bhaven Sampat, *What To Do About Bad Patents*, REGULATION, Winter 2005–2006, at 10, 12; George H. Pike, *Patent Reform Heats Up*, INFO. TODAY, July/Aug. 2005, at 17.

65. For example, there are many patented products that lack competitive market pricing because of a temporary monopoly on the underlying patent. In IP literature, the "deadweight loss" is the cost to society from a patent owner with a temporary monopoly charging consumers at the patent-protected price rather than at a competitive market price. The deadweight losses for patented prescription drugs contribute to the general difficulty of obtaining prescription drugs, because the patent effectively prevents others from creating competition and thus makes the drugs too expensive. *See, e.g.*, posting by Dean Baker, *Bird Flu, Bird Brains, and Economists* to http://maxspeak.org/mt/archives/001689.html (on file with New York University Journal of International Law and Politics); *see also* Daniel J. Gifford, *How Do the Social Benefits and Costs of the Patent System Stack Up in Pharmaceuticals?*, 12 J. INTELL. PROP. L. 75, 122 (2004).

66. *See* HISAMITSU ARAI, INTELLECTUAL PROPERTY POLICIES FOR THE TWENTY-FIRST CENTURY: THE JAPANESE EXPERIENCE IN WEALTH CREATION 33-34 (2000) (stating that forty-five percent of Japanese companies file patents for the purpose of blocking the development and sale of similar goods).

67. *See* FEDERAL TRADE COMMISSION, TO PROMOTE INNOVATION: THE PROPER BALANCE OF COMPETITION AND PATENT LAW AND POLICY 5 (2003), *available at* http://www.ftc.gov/os/2003/10/innovationrpt.pdf. *See generally* Jay Pil Choi, *Live and Let Live: A Tale of Weak Patents*, 3 J. EUR. ECON. ASS'N 724 (2005).

68. *See* Glenn R. Simpson, *A New Twist in Tax Avoidance: Firms Send Best Ideas Abroad*, WALL ST. J., June 24, 2002, at A1.

porate tax base of MNEs has occurred in much of the world. More sophisticated international cooperation and treaty provisions are needed to impose appropriate minimum taxes on patents through the international registration system and periodic renewals of the legal protection of IP.

B. *Commercial Realities, Valuation, Accounting, and Tax Concerns*

Four important factors exist for understanding transfer pricing concerns for patents and other IP. The first factor is the common commercial practice of selling a patent not individually, but together with a group of patents and other IP assets. A second factor is the difficulty in establishing the value of IP. A third factor is that current financial accounting standards for IP fail to provide adequate tracking of IP assets. A fourth factor, not discussed in this Part, is the location in which the related expenses for the development of IP are sourced for tax purposes.

1. *Commercial Practices*

An MNE Group often conveys licenses of IP rather than selling underlying property rights.[69] Licenses of IP rights often package several patents and "know-how" together as "technology licenses."[70] Licenses allow affiliated foreign MNEs to use the IP developed or owned by another related or affiliated MNE, subject to the MNE Group's strategic plans and restrictions.[71] A license creates additional legal rights in IP arising from contract law. For example, a license of the

69. *See* OECD Guidelines, *supra* note 1, at VI-7, ¶ 6.16. *See generally* PHILIP MENDEZ, TO LICENSE A PATENT—OR, TO ASSIGN IT: FACTORS INFLUENCING THE CHOICE (n.d.), *available at* http://www.wipo.int/export/sites/www/sme/en/documents/pdf/license_assign_patent.pdf.

70. *See* OECD Guidelines, *supra* note 1, at VI-7, ¶ 6.18. *See generally* Ethan Horwitz, *Patent & High Technology Licensing*, *in* PATENT & HIGH TECHNOLOGY LICENSING 57, 62-63 (Ethan Horwitz & Mark S. Holmes eds., 2005).

71. *See generally* Marina Lao, *Unilateral Refusal to Sell or License Intellectual Property and the Antitrust Duty to Deal*, 9 CORNELL J.L. & PUB. POL'Y 193 (1999). A license may have various limitations, which may be based on geographic use, type of product, or channels of trade. An "exclusive license" gives permission to one party only. *See* ELIZABETH D. HOCHBERG ET AL., E-Z REVIEW FOR INTELLECTUAL PROPERTY 331 (2003).

rights to use IP exists in return for making royalty payments.[72] The complexity of valuing individual IP usually increases with strategies for various sophisticated licensing arrangements[73] and cost sharing agreements.[74]

IHCs[75] are common entities for moving the legal ownership of patents and trademarks to another jurisdiction.[76]

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72. The license category in the U.S. definition of intangibles also includes contracts and franchises. Treas. Reg. § 1.482-4(b)(4) (as amended in 2006). Two remaining categories of intangibles in U.S. tax law include all other similar items within the definition of "intangibles." *Id.* § 1.482-4(b)(5), (6).

73. Complex licensing arrangements may include IHCs, sub-licensing, and cross-licensing agreements. IHCs exist to own and manage the MNE's intangibles. MNE Groups often establish an IHC in a tax haven. *See* Jeffrey L. Rubinger & William B. Sherman, *Holding Intangibles Off-Shore May Produce Tangible U.S. Tax Benefits*, 37 TAX NOTES INT'L 907, 907 (2005). Rather than acquiring the ownership of intangibles directly, often ownership is acquired through a license. In turn, the IHC usually grants sub-licenses for which it receives royalties subject to little or no taxes. *Id.*; *cf.* Norbert J.T. Rosmalen, *New Life for Netherlands Royalty Conduit Companies*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 932 (2005). A sub-licensing agreement may involve co-marketing, such as GlaxoSmithKline's promotion of a drug in China. *See* GSK ANNUAL REPORT, *supra* note 6, at 8. "Cross-licenses" exist when two or more license holders exchange licenses so that each benefits from the other's intangibles. *See, e.g.*, Paul Kallender, *Microsoft, Toshiba Cross-License Patents*, INFOWORLD DAILY NEWS, May 13, 2005, http://www.infoworld.com/article/05/05/13/HNmstoshcrosslicense_1.html. Sony has explained that cross-licensing agreements were becoming necessary because of the number of patents created in the last decade for digital and networking technologies. *Id.*

74. "Cost sharing" or "cost contribution agreements" are another common arrangement for importing the value of IP when two or more controlled taxpayers jointly develop the IP. *See* OECD Guidelines, *supra* note 1, at G-4. They are also known as "cost sharing arrangements" in the United States. *See* Treas. Reg. § 1.482-7 (as amended in 2004); Treas. Reg. § 1.482-9T (as amended in 2006). Cost contribution arrangements are often interpreted differently by different countries. *See* Clark Chandler & Richard Boykin, *Transfer Pricing: Introduction*, INT'L TAX REV., July 2004 Supp., at 3.

75. *See* Rubinger & Sherman, *supra* note 73, at 907.

76. The ease of moving IP ownership for tax purposes became a major concern when IP was moved abroad. *See, e.g.*, Mitchell J. Tropin, *Full Regulatory Regimes Becoming the Norm Worldwide*, 10 BNA TAX MGMT. TRANSFER PRICING REP. 767 (2002) (discussing Canada). State governments are also concerned when IP is moved within the United States to another state, usually Delaware. For example, since 1993, at least twelve states within the United States have reacted to the development of IHCs with legislative add-back statutes. These add-back statutes, also known as "anti-PIC" (anti-passive investment companies) statutes, prevent corporations from lowering their state taxes by deducting royalty payments to the IHC for use of the IP. *See generally*

When IHCs are established in tax havens such as Switzerland,[77] there is usually little non-tax commercial justification.[78] The major non-tax reason for moving patents abroad to an IHC is usually to make the MNE's financial statements appear stronger by not having to report as much deferred tax on the MNE's balance sheet.[79] Governments should not consider this

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Edward K. Dennehy & Stephen E. Ehrlich, *PICking Away at Passive Investment Companies: States Enact Legislation to Curtail Revenue Losses,* 33 STATE TAX NOTES 777 (2004). Some states provide an exception for IP expenses paid to a related MNE in a foreign country having a tax treaty with the United States. *See, e.g.*, N.Y. TAX LAW § 208(9)(o)(2)(B)(ii) (McKinney 2005). Other states are expected to adopt similar provisions because the Multistate Tax Commission is developing a similar model statute. *See MTC Developing Model Statute to Require Certain Interest, Intangible Expense Addback,* 14 BNA TAX MGMT. TRANSFER PRICING REP. 48 (2005).

77. Four cantons (provinces) in Switzerland are particularly considered tax havens: Graubunden, Schaffhausen, Schwyz, and Zug. Cordia Scott et al., *OECD Targets Switzerland in New Tax Haven Blacklist,* 31 TAX NOTES INT'L 91, 91 (2003). For example, in Switzerland's canton of Zug, an MNE could establish an IHC and might acquire a tax rate as low as three percent of the income on the IP through an advance ruling. Discussion with Thomas O'Donnell, Partner, Baker & McKenzie, in New York, N.Y. (June 2, 2005). The EU Commission President Jose Barraso has warned Switzerland that these cantons are applying a discriminatory tax regime for IHCs. *See* Simon Thönen, *Barroso Raises the Tax Stakes with Switzerland,* SWISSINFO, July 7, 2006, http://www.swissinfo.org/eng/swissinfo.html?siteSect=881&sid=6879017.

78. For IP that is territorially based, MNE Groups might desire to have the ownership in the relevant country or an associated region of the world. For example, some intangibles such as "know-how" are moved to another country, in theory, to provide technical support to customers who might need the right to use the proprietary technology. An alternative approach used by some MNE Groups is to move the scientific jobs that create the IP to a low cost country, such as India. *See generally* Larry Dignan, *Leaping, Then Looking,* BASELINE, September 5, 2003, http://www.baselinemag.com/article2/0,1397,1253344,00.asp (discussing corporate rationale for offshore outsourcing in technology).

79. *See* Paul Dau & Rod Donnelly, *Globalization of Intangibles-Based Businesses: Tax Aspects,* 9 STAN. J. L. BUS. & FIN. 1, 7 (2003). *See generally* FINANCIAL ACCOUNTING STANDARDS BOARD (FASB), STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 109, ACCOUNTING FOR INCOME TAXES (1992), *available at* http://fasb.org/pdf/fas109.pdf; FINANCIAL ACCOUNTING SERIES, FASB INTERPRETATION NO. 48, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES (2006), *available at* http://www.fasb.org/pdf/fin%2048.pdf; INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB), STATEMENT OF INT'L ACCOUNTING STANDARDS NO. 12, INCOME TAXES (1998). For a discussion of the relation between transfer pricing and FASB Statement No, 109, see generally Molly Moses, *FASB Draft on Uncertain Tax Positions Seen to Clash with Transfer Pricing Analysis,* 14 TAX MGMT. TRANSFER PRICING REP. 892 (2006).

accounting incentive a real business reason to justify moving the IP. Instead, the accounting concern represents financial statement manipulation by MNE Groups that various accounting standards boards[80] and securities law regulators should correct.[81]

2. *Challenges in IP Valuation*

The valuation of IP is difficult to establish, and these valuation problems represent another reason that MNE Groups often use IP to engage in abusive tax avoidance. The economic value of IP is primarily determined by the economic and legal environment in which the IP is embedded, the market demand for the IP, and the existence or absence of close substitutes.[82] Valuation experts usually identify assumptions in establishing value, such as expected future earnings estimates, the rate of the average cost of capital, and other factors including the discount rate.[83] The valuation of IP is also affected by its tax treatment.[84]

80. The two major accounting standards boards are the International Accounting Standards Board (IASB), whose standards the European Union adopted effective 2005, and the U.S. Financial Accounting Standards Board (FASB). These two accounting boards have a "convergence project" to harmonize their standards. *See* FASB, Short-Term International Convergence, http://www.fasb.org/project/short-term_intl_convergence.shtml (last visited Jan. 8, 2008). *See generally* Thomas C. Pearson, *Creating Accountability: Increased Legal Status of Accounting and Auditing Authorities in the Global Capital Markets (U.S. and EU)*, 31 N.C. J. INT'L L. & COM. REG. 65 (2005).

81. Government securities law regulators generally belong to the International Organization of Securities Commissions (IOSCO). *See* International Organization of Securities Commissions, Members Lists, http://www.iosco.org/lists/ (last visited Jan. 12, 2008).

82. BOOS, *supra* note 3, at 31-32. Thus, patents are sometimes acquired to block the development of close substitutes, prevent other companies from using the technology, or for advantage in cross-licensing arrangements. *See* ARAI, *supra* note 66, at 33-34.

83. An IP expert for the MNE DHL assumed about an 8% growth rate, 14% cost of capital, and a 13% discount rate. The Tax Court rejected these assumptions as less reasonable than the government's analysis. DHL Corp. v. Comm'r, 76 T.C.M. (CCH) 1122, 1239 (1998), *rev'd*, 285 F.3d 1210 (9th Cir. 2002). For more discussion of this case, see *infra* note 224.

84. For general information on other aspects of U.S. tax treatment of intangibles, see Harry Ballan, William C. Gifford & Bruce A. Cohen et al., *Basic U.S. and International Tax Issues for BioTech Lawyers*, 805 PRACTISING L. INST. 565 (2004).

The valuation of IP is hard to establish reliably in part because IP often fluctuates in value significantly. The fluctuation occurs not only over time, but at any one time depending upon the key assumptions of the inherent risks associated with the IP. These risks can include liability concerns or the possibility that competitors will create new and better products.[85] Thus, the Organisation for Economic Co-operation and Development (OECD)[86] Guidelines[87] recognize that it is often difficult to attribute a distinct value to each piece of IP on an ongoing basis.[88]

The valuation of IP poses difficulties for transfer pricing decisionmaking and government oversight for three major reasons.[89] First, comparables for such assets seldom exist.[90]

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85. GlaxoSmithKline's description of its competition recognizes that "[p]harmaceuticals may be subject to competition from other products during the period of patent protection and, once off patent, from generic versions." GSK ANNUAL REPORT, *supra* note 6, at 22; *see also* CANADIAN REVENUE AGENCY, PUBL'N NO. 87-2R, INTERNATIONAL TRANSFER PRICING 15, ¶ 141 (1999), *available at* http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/ic87-2r-e.pdf.

86. The OECD is an international organization of thirty member countries primarily dominated by European countries. The OECD proposes government policies in various areas including transfer pricing. *See* About OECD, http://www.oecd.org (last visited Oct. 2, 2007); OECD Center for Tax Policy and Administration, http://www.oecd.org/about/0,3347,en_2649_34897_1_1_1_1_1,00.html (last visited Oct. 2, 2007).

87. The OECD Guidelines have a substantial influential effect on laws and practices. *See, e.g.*, Swiss Federal Tax Administration, Mar. 19, 2004, Taxation of Service Companies, No. 1-004-DV-2004-e, *available at* http://www.estv.admin.ch/d/dvs/kreisschreiben/1-004-DV-2004-e.pdf (explaining that when taxing MNEs, Swiss cantons must consider OECD's Transfer Pricing Guidelines). The OECD's influence also extends outside of OECD countries. For example, African countries lacking specific transfer pricing legislation might use the OECD Guidelines as an interpretation for their anti-tax-avoidance legislation. Press Release, Ernst & Young, Transfer Pricing in Africa Not Practiced Effectively (Nov. 23, 2004) (statement of Sean Kruger) (on file with New York University Journal of International Law & Politics).

88. *See* OECD, *Special Considerations for Intangibles*, *in* OECD Guidelines, *supra* note 1, at VI-3. In 2006, the OECD released a draft of a study on comparables which attempts to provide MNEs with more guidance. *See* OECD, Comparability, *supra* note 4.

89. When tax is not at issue, the primary approaches to the valuation of intangibles are the market approach, the income approach, and the cost approach. BOOS, *supra* note 3, at 9-10.

Patents are rarely traded on external markets.[91] Usually MNEs are unwilling to sell their patents, but might license out some of the rights to use the intangible asset. Second, IP rights are often transferred in combination with tangible assets or services, known as "embedded intangibles."[92] Buyers may want to acquire a product that relies on a combination of IP and other assets. Third, intangibles other than patents are particularly difficult to detect because they are not reported in financial statements.[93]

3. *Accounting and Tax Concerns*

Financial accounting for IP is generally inadequate.[94] The weakness in accounting standards regarding IP makes it easier for MNE Groups to engage in abusive tax avoidance related to the transfer pricing of IP. The accounting standards

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90. *See* Gordon V. Smith & Russell L. Parr, *Valuation Issues in Transfer Pricing, in* TRANSFER PRICING HANDBOOK 58 (Robert Feinschreiber ed., 1998).

91. Given that it is unrealistic to expect an MNE to place an intangible on the open market, one industry economist with the IRS argues the appropriate model for valuation is a bilateral monopoly. Alan McInnes, *Intangibles Ownership, Arm's-Length Royalties, and the Irrelevance of the Competitive Model*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 173 (2005).

92. Prop. Treas. Reg. § 1.482-4(f)(3)-(6), 68 Fed. Reg. 53448, 53449 (Sept. 10, 2003); *see* discussion *infra* Part II.3 on ownership of intangibles. An example of an embedded intangible is a camera which incorporates new technology. *See generally* Richard L. Doernberg, *Taxation Silos: Embedded Intangibles And Embedded Services Under U.S. Law*, 41 TAX NOTES INT'L 561 (2006).

93. BOOS, *supra* note 3, at 7. Intangibles are tracked by certain proxies such as royalties, license fees, and dividends. *Id.* More than seventy-five percent of all private R&D expenditures worldwide are accounted for by MNEs. Most royalties, licenses, and management fees are intra-firm payments flowing from foreign affiliate MNEs to the parent corporation MNE. *Id.* (citing Lorraine Eden et al., *The Production, Transfer, and Spillover of Technology: Comparing Large and Small Multinationals as Technology Producers, in* SMALL AND MEDIUM SIZED ENTERPRISES IN THE GLOBAL ECONOMY 121, 122 (Zoltan J. Acs & Bernard Yeung eds., 1999)).

94. For example, in 2007, the U.S. Financial Accounting Standards Board amended FAS 142 regarding the determination of useful life and amortization of renewable intangible assets. *See* FASB, Project Updates: Determination of the Useful Life and Amortization of Intangible Assets, http://www.fasb.org/project/intangible_assets.shtml (last visited Jan. 12, 2008) [hereinafter FASB, Project Updates]; *see also* FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 142, GOODWILL AND OTHER INTANGIBLE ASSETS (2001), *available at* http://www.fasb.org/pdf/fas142.pdf.

in most countries allow internally-generated IP to be expensed rather than capitalized as investments.[95] As a result, IP generally does not appear on an MNE Group's balance sheet unless acquired through a purchase,[96] in which case the IP appears only as "goodwill."[97]

IP is generally not recorded or disclosed in an MNE Group's financial statements or its footnotes. Even if an MNE Group measures its IP,[98] very little disclosure about IP is required in the financial statement footnotes.[99] Furthermore,

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95. *See* Isabel Verlinden & Patrick Boone, *Reporting Intellectual Property*, *in* IP VALUE 2005 (2005), *available at* http://www.buildingipvalue.com/05_TI/031_034.htm.

96. Martin Przysuski et al., *Transfer Pricing of Intangible Property: A Canadian–U.S. Comparison*, TAX PLAN. INT'L TRANSFER PRICING, Dec. 1, 2004, at 7. However, accounting standards boards are reviewing intangibles. *See, e.g.*, FASB, Project Updates, *supra* note 94.

97. "Goodwill" is an asset initially equal in value to the amount remaining after subtracting both liabilities and owner's equity from the net fair market value cost of other identifiable assets. Goodwill is reported on the financial statements at "cost" less any "accumulated impairment losses" in accordance with IASB, STATEMENT OF INT'L ACCOUNTING STANDARDS NO. 36, IMPAIRMENT OF ASSETS (2004). *See also* IASB, *International Financial Reporting Standard 3: Business Combinations*, in INTERNATIONAL FINANCIAL REPORTING STANDARDS 2004 271 (2004).

98. In a survey of senior executives from around the world on the management of strategic assets, about half of those surveyed considered IP the primary source of long-term shareholder wealth creation, but about ninety-five percent admitted that they did not have a robust system to measure the performance of their IP. News Release, Accenture, Managing Intangible Assets is a Top Issue for Senior Executives, Accenture Study Finds (Jan. 29, 2004), *available at* http://accenture.tekgroup.com/article_display.cfm?article_id=4076.

99. *See* Roya Ghafale, Getting a Grip on Accounting and Intellectual Property, http://www.wipo.int/sme/en/documents/ip_accounting.html (last visited Oct. 2, 2007). However, a growing number of MNEs are starting to report on their intangibles, particularly in Scandinavian countries. *See* Dina Gray, *Reporting on Intangibles*, BUSINESSINTELLIGENCE.COM, http://www.businessintelligence.com//ex/asp/code.95/xe/article.htm (last visited Oct. 2, 2007) ("Scandinavian countries appear to be leading the field by not only discussing their people and processes but also disclosing intangible resource measures in a separate section in their annual reports."); *see also* Management's Discussion and Analysis of Financial Condition, 17 C.F.R. § 229.303 (2002) (requiring that U.S. public companies disclose more financial information).

MNE Groups generally provide very little voluntary disclosure of IP.[100]

Auditor review of MNE "internal controls" for accounting information has begun to impact transfer pricing discussions.[101] Auditors review the MNE's transfer pricing studies and related documentation prepared for tax purposes.[102] The auditors then determine if the MNE has followed the transfer pricing practices articulated in its transfer pricing studies.[103] Stringent use of auditing standards could help reduce the potential for MNE Groups to engage in abusive tax avoidance through transfer pricing manipulation of IP.[104] Although transfer pricing regimes in different countries are generally similar, international reforms are needed to increase the effectiveness of transfer pricing regulation and thus to reduce transfer pricing manipulation by MNE Groups and prevent abusive tax avoidance.

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100. *See* Douglas J. Skinner, AAA Financial Accounting Standards Committee, *Implications of Accounting Research for the FASB's Initiatives on Disclosure of Information about Intangibles*, 17 ACCT. HORIZONS 175, 180 (2003). Disclosures are generally limited either to warnings about a product arising from IP or the information needed for Initial Public Offerings. *See, e.g.*, Sunesis Pharmaceuticals, Inc., Registration Statement (Form S-1), at 13-15, (Dec. 23, 2004), *available at* http://www.sec.gov/Archives/edgar/data/1061027/000104746904038327/a2148549zs-1.htm.

101. In the United States, auditors of public companies must also attest to management's report on the company's internal controls. Management Assessment of Internal Controls, 15 U.S.C. § 7262(b) (2002) (codified as part of the Sarbanes-Oxley Act of 2002).

102. For example, transfer pricing documentation in Germany must follow the German Administrative Principles. *See* Alexander Voegele et al., *Germany's Draft Administrative Principles: Focus on Documentation, Economic and Quantitative Analysis*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 751 (2004); *cf.* IRS, LMSB Commissioner Directive: Transfer Pricing Compliance Process (Jan. 23, 2003), *available at* http://www.irs.gov/businesses/international/article/0,,id=156262,00.html (explaining how to structure the documentation required under Treas. Reg. §1.6662-6(d)(2) (as amended in 2006)).

103. Molly Moses, *Meeting the Requirements of Sarbanes-Oxley*, TAX PLAN. INT'L TRANSFER PRICING, May 26, 2005, at 14.

104. Because accounting and auditing involve professional judgment, some legitimate differences in opinion will always exist. Requiring more precise accounting and auditing standards is insufficient to resolve all transfer pricing disputes.

III. The Abusive Tax Avoidance Problem

Tax avoidance is the use of legal tax strategies to minimize taxes. Traditionally, valid non-tax business reasons exist for tax avoidance. Abusive tax avoidance transactions, however, are distinguishable.[105] Abusive tax avoidance involves "transactions promoted for the promise of tax benefits with no meaningful change in the taxpayer's economic position. These abusive transactions typically have no economic or business purpose other than reducing taxes."[106] Multiple ownership tiers and complex ownership structures most often characterize abusive tax avoidance.[107]

Transfer pricing manipulation by MNE Groups resulting in abusive tax avoidance is illustrated in Part III.A through the GlaxoSmithKline case and its resulting $3.4 billion, record-high transfer pricing settlement. The problem of abusive tax avoidance has resulted in an explosive worldwide growth of transfer pricing regimes that attempt to prevent transfer pricing manipulation of IP. These regimes are discussed in Part III.B. In Part III.C, I argue that because outdated and ineffective transactional methods are often used to determine the transfer pricing of IP, governments should mandate the use of valuation methods to establish appropriate pricing of these assets.

A. *Glaxo: An International Transfer Pricing Dispute*

The MNE Group GlaxoSmithKline (Glaxo) recently settled a transfer pricing dispute in the United States for $3.4 billion. The magnitude of this settlement helps illustrate the scope of the problem of abusive tax avoidance. Glaxo is an MNE Group headquartered in the United Kingdom and with eighty-four principal subsidiaries throughout the world.[108] Its

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105. Closing down abusive corporate tax transactions is the highest enforcement priority of the IRS' "large and mid-sized business division." Rettig, *supra* note 2, at 3. The IRS has identified over thirty specific types of abusive transactions, referred to as "listed transactions." I.R.S. Notice 2004-41 I.R.B. (Oct. 12, 2004).

106. California Franchise Tax Board, Memorandum of Agreement Pertaining to Abusive Tax Avoidance Transactions, *available at* http://www.ftb.ca.gov/law/tax_shelter/moaatat.html.

107. *Id.*

108. GSK Annual Report, *supra* note 6, at 147-49.

primary business is the creation and manufacture of pharmaceutical drugs.[109] Cross-border transactions of successful pharmaceuticals having enormous profit margins have attracted the attention of revenue agents.[110] In 2000, when the predecessor of Glaxo (GlaxoWellcome) merged with SmithKline Beecham to form Glaxo, the merger triggered a transfer pricing audit in the United States.[111] Glaxo soon also faced transfer pricing audit adjustments in Canada and Japan.[112]

Glaxo's sales of drugs in the United States generated almost $30 billion in revenues from 1989 to 1999.[113] During this same period, Glaxo paid about $1.3 billion in U.S. taxes.[114] Glaxo claimed that the United Kingdom had already taxed the disputed MNE Group's profits, arguing that any reallocation by the United States would result in double taxation of Glaxo.[115]

For example, approximately seventy-five percent of Glaxo's income in the United States was attributable to an ef-

109. Glaxo defines itself as a global healthcare MNE group engaged in the creation and discovery, development, manufacture, and marketing of pharmaceutical products. *Id.* at 89. The U.S. subsidiary of Glaxo was a fully integrated company that owned the relevant U.S. trademark IP for U.S. tax purposes. Kevin A. Bell, *IRS Answers Glaxo, Sets Stage for Feud on Marketing Intangibles*, 103 TAX NOTES TODAY 1218, 1219 (2004).

110. For example, Canada, Japan, and the United Kingdom have assessments pending against Glaxo. GSK ANNUAL REPORT, *supra* note 16, at 98 n.12. Note that in the pharmaceutical industry, MNEs are "fully dependent upon the various governmental controls of the nation states they are serving," from the research and development of the drugs through the manufacturing and marketing of a new product. Karl Wündisch, *Pharmaceutical Industry and Transfer Pricing: Anything Special?*, INT'L TRANSFER PRICING J., Nov./Dec. 2003, at 204, 204. These controls "surely have an effect on the transfer pricing of the enterprises." *Id.* at 210.

111. *U.S. Adds $1.9 Billion to Glaxo's Tax Bill*, ASIAN WALL ST. J., Jan. 28, 2005, at M7.

112. *See generally* Tamu N. Wright, *Glaxo Sees Global Scrutiny for Transfer Pricing of Popular Drugs*, 12 BNA TAX MGMT. TRANSFER PRICING REP. 1041 (2004).

113. Glenn R. Simpson, *Glaxo Faces Allegations of Tax Underpayment in U.S.* ASIAN WALL ST. J., June 12, 2002, at A7.

114. *GlaxoSmithKline Faces Huge U.S. Tax Liability*, PITTSBURGH POST-GAZETTE, Jan. 8, 2004, at C13.

115. *Second Glaxo Petition Includes Cost Sharing, Company Contests $5.4 Billion in Allocations*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 1225 (2005).

fective ulcer medicine drug called Zantac.[116] The U.K. parent company owned the patent that produced Zantac.[117] Glaxo and the United Kingdom believed that the U.K. parent corporation deserved most of Zantac's enormous profits from its U.S. sales. They contended that the U.S. subsidiary MNE was a mere distributor for the U.K. parent corporation MNE, and not a licensee of a fully integrated pharmaceutical company.[118]

The IRS, on the other hand, alleged that the U.S. subsidiary of Glaxo overpaid its U.K. parent company MNE for the highly profitable drugs, thereby reducing U.S. profits and U.S. taxes. The IRS argued that marketing efforts by the U.S. subsidiary were the determining factor in the success of Zantac[119] and Glaxo's other U.S. drug sales.[120] The IRS eventually demanded almost $8 billion worth of back taxes and penalties.[121]

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116. Pim Fris & Sébastien Gonnet, *A European View on Transfer Pricing After Glaxo*, TAX PLAN. INT'L TRANSFER PRICING, Nov. 2006, at 2, 3; *see also* Kevin A. Bell, *IRS Assesses Glaxo, Sets Stage for Feud on Marketing Intangibles*, 103 TAX NOTES TODAY 1218, 1218 (2004).

117. Zantac was the world's best selling drug from the mid-1980s to the mid-1990s, at one point accounting for more than half the company's total revenues. Matthews & Whalen, *supra* note 5, at A19.

118. One of Glaxo's defensive tactics in the case was to raise other side issues. Glaxo claimed it was subject to discriminatory treatment because it was unable to obtain an Advance Pricing Agreement (APA) in 1994 when SmithKline Beecham, a direct competitor, had an APA agreement for a similar drug. *See* Bob Ackerman et al., *Global Transfer Pricing Update*, 37 TAX NOTES INT'L 469, 470 (2005); *see also Glaxo Judge Denies IRS Motion Seeking to Eliminate $1 Billion Discrimination Claim*, 13 TAX MGMT. TRANSFER PRICING REP. 1166, 1116 (2005). This APA was publicly released after the Glaxo settlement. *See generally Text of 1993 SmithKline Beecham APA Available*, TAX NOTES TODAY, Sept. 18, 2006, at 180-78.

119. Zantac was the second leading ulcer medication in the United States. Molly Moses, *U.S. Marketing Intangibles Stance in Glaxo: Wave of the Future?*, 12 BNA TAX MGMT. TRANSFER PRICING REP. 995 (2004).

120. Market demand is a determinant of the underlying economic value of IP. BOOS, *supra* note 3, at 31-32. In the United States, the Glaxo MNE Group "has its highest margins and most sales for any country." GSK ANNUAL REPORT, *supra* note 6, at 73. Glaxo's annual report for 2002, for example, reveals that Glaxo earned fifty-three percent of its total revenue in the United States. GLAXOSMITHKLINE, 2002 ANNUAL REPORT 68 (2003).

121. Andrew Jack, *GSK Tax Bill Raised to Dollars 7.8Bn.*, FINANCIAL TIMES (London), Jan. 27, 2005, at 21. Glaxo's income in the United States was increased by $3.3 billion for disallowing costs of goods sold, $2.3 billion for adding interest income from constructive loans from Glaxo-U.S. to Glaxo-U.K., and lesser amounts for royalty adjustments for cost sharing buy-in pay-

The taxes arose from adjusting Glaxo's costs of goods sold, royalties, and interest income involving inter-company transactions for Glaxo's drugs.[122] Glaxo tried to settle with the IRS by referring the dispute to a competent authority under the bilateral tax treaty between the United States and the United Kingdom.[123] The governmental discussions broke down, however, when the United Kingdom supported Glaxo in rejecting the proposed U.S. transfer pricing adjustment.[124] The IRS took Glaxo to court to preserve evidence in preparation for the anticipated trial.[125] In September 2006, the two parties settled

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ments, license fees, and tax credit adjustments. *Second Glaxo Petition Includes Cost Sharing, Company Contests $5.4 Billion in Allocations*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 1225 (2005).

122. The IRS capped Glaxo's United Kingdom parent's royalty payments at 15% and limited its manufacturing markup to 30%. Audrey Nutt, *Glaxo, IRS Settle Transfer Pricing Dispute*, 112 TAX NOTES TODAY 1020, 1020 (2006).

123. A new U.S.-U.K Tax Convention became effective in the United States in 2003. Article 9, entitled "Associated Enterprises," provides that if one contracting state has charged tax on an arm's-length basis, the other country should make a compensating correlative adjustment by a similar amount of profits. Article 9 is implemented under the "mutual agreement procedures" of article 25 to eliminate double taxation. 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., July 24, 2001, T.I.A.S. 9682.

124. The U.S. proposed regulation on intangibles, discussed *infra*, may have been a crucial factor in why the competent authority negotiations broke down. Also, the need for binding arbitration of facts in unresolved transfer pricing cases is illustrated by the initial failure of the U.S. and U.K. competent authorities to resolve the multi-billion dollar double taxation dispute in *Glaxo*. Arbitration is usually more effective and less costly than litigation. *See generally Competent Authority: U.S., U.K., Japanese Officials Endorse Binding Arbitration for Unresolved MAP Cases*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 863 (2004) (containing a statement by Robert Green, IRS, Large and Mid-Size Business Division, Director—International). However, arbitration can cause problems of its own. *See* Mitchell J. Tropin, *EU Faces Unresolved Arbitration Issues, Questions Over Number of Cases, Penalties*, 15 BNA TAX MGMT. TRANSFER PRICING REP. 65 (2006).

125. In 2001, the Tax Court enabled lawyers to take depositions of two key former Glaxo executives. GlaxoSmithKline Holdings v. Comm'r, 117 T.C. 1 (2001). In spring 2006, both parties sought a court order obtaining further documents from the other side. Tamu N. Wright, *IRS Seeks Access to Glaxo Computer System, Worldwide Records to Close Discovery 'Gaps,'* 15 BNA TAX MGMT. TRANSFER PRICING REP. 11 (2006). Glaxo had already provided 4.5 million pages of documents. Tamu N. Wright, *Glaxo, Internal Revenue Service Near Agreement on Marketing Documents*, 15 BNA TAX MGMT. TRANSFER PRICING REP. 85 (2006); *see also* Tamu N. Wright, *IRS Refuses to Turn Over Documents, An-*

the tax dispute for the seventeen-year period between 1989 and 2005.

In settling the GlaxoSmithKline case,[126] IRS Commissioner Mark Everson stated that transfer pricing issues "are one of the most significant challenges" tax agencies face.[127] The success and profits of Glaxo's "number two" drug in the United States were primarily based on successful marketing and sales in the U.S. market, rather than the patents that generated the drug, as Glaxo claimed.[128] An MNE is likely to argue that it has created an improved drug, such as a drug with fewer side effects, so that the value lies in the patent rather than the marketing.[129] But one of Glaxo's problems was that it could not prove clear ownership trails for much of its IP, including the question of how Glaxo funded research within its MNE Group and took legal ownership of its drugs.[130]

The sheer size of the transfer pricing settlement for Glaxo suggests that abusive tax avoidance was occurring in relation to the transfer pricing of its IP.[131] Although Glaxo publicly maintains the validity of its prior tax position, the Glaxo MNE Group concluded that it was in the best interests of the shareholders to settle. Settlement removes probable litigation costs and the uncertainty of potential greater liability.[132] Although Glaxo still has remaining transfer pricing audit issues with the United Kingdom, Canada, and Japan, the company has already booked reserves in its financial statements so that poten-

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swers Questions on APAs in Glaxo Case, 14 BNA Tax Mgmt. Transfer Pricing Rep. 947 (2006).

126. IRS, Report on the Application and Administration of Section 482 (1999), at ch. 7(III)(B), *available at* www.irs.gov/pub/irs-pdf/p3218.pdf [hereinafter IRS, Report § 482].

127. Nutt, *supra* note 122, at 1020.

128. *IRS Argues Activities of Glaxo Subsidiary Improved Drugs Sold in the United States*, 14 BNA Tax Mgmt. Transfer Pricing Rep. 157 (2005).

129. Moses, *supra* note 119, at 995.

130. *Id.* at 997 (statement of Dennis Michaels, Johnson & Johnson).

131. Merck & Co., another pharmaceutical MNE Group, has disclosed that its transfer pricing dispute with Canada is for $1.76 billion in taxes and interest, arising from its transfer of a patent for a highly successful drug to a subsidiary in Barbados, a tax haven. John Carreyrou & Jesse Drucker, *Merck Adds U.S., Canada Tax Disputes to Woes*, Wall St. J., Nov. 8, 2006, at A3.

132. *See* Press Release, GlaxoSmithKline, GSK Settles Transfer Pricing Tax Dispute with IRS (Sept. 11, 2006), *available at* http://us.gsk.com/ControllerServlet?appId=4&pageId=402&newsid=953.

tial settlements will probably not further negatively impact the MNE Group in terms of its anticipated profits.[133]

Glaxo appropriately realized that litigation is ordinarily not the most efficient way to resolve transfer pricing disputes.[134] The most difficult transfer pricing cases often involve multiple types of IP, usually including a patent. Allocating the income among the IP is a job that the courts have little expertise in performing.[135] The Glaxo settlement was a major victory for the U.S. government in acquiring a record-high settlement amount. The large settlement sends a message to MNE Groups that prior U.S. government litigation failures on IP are not predictive when litigating transfer pricing cases.[136] Thus, MNE Groups should find transfer pricing litigation generally less attractive in the future.

Litigation is a time-consuming and expensive process for resolving transfer pricing disputes and provides little definitive guidance. A more effective approach, as discussed in Part IV *infra*, would be for governments to adopt internationally uniform standards to curb transfer pricing abuse.

B. *The Explosive Growth of Transfer Pricing Regulation Worldwide*

Transfer pricing regulation by governments to combat abusive transfer pricing practices has exploded worldwide. Most of the growth has occurred since the mid-1990s, when the United States enacted transfer pricing documentation requirements and associated penalties. Part III.B.1 discusses how the U.S. transfer pricing regulation developed. The

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133. GSK ANNUAL REPORT, *supra* note 6, at 98.

134. Note that worldwide litigation over transfer pricing adjustments is increasing, although the number of such cases in the U.S. courts is decreasing. Tamu N. Wright, *Pending Litigation: Evolution of Transfer Pricing Laws Shaping Litigation Worldwide*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 883 (2006).

135. All parties could benefit from a settlement process of legal disputes on transfer prices that resembles the WTO's resolution of international IP controversies. *See generally* WTO, Dispute Settlement Gateway, http://www.wto.org/english/tratop_e/dispu_e/dispu_e.htm#intro (last visited Jan. 25, 2008).

136. *See* Press Release, IRS, IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute (Sept. 11, 2006), *available at* http://www.irs.gov/newsroom/article/0,,id=162359,00.html (statement of IRS Commissioner Everson).

United States was the first country to regulate MNE Groups' transfer pricing and has continued to lead transfer pricing developments in the world. Part III.B.2 discusses the wave of countries that have followed the United States in enacting transfer pricing regulation, including not only industrialized OECD countries but also "developing economies."[137] Today, the growth in the number of governments concerned about transfer pricing manipulation and the increasing adoption of transfer pricing regulation throughout the world has even started to impact tax treaties.[138]

1. *Development of U.S. Transfer Pricing Regulation*

In 1928, the United States became the first country to regulate transfer prices.[139] Like most countries with transfer pricing legislation before the 1990s, though, the U.S. statutory law and initial regulation were essentially ineffective.[140] The U.S. Internal Revenue Code created section 482, which allowed the IRS to reallocate any item of gross income, deductions, or tax credits between or among a "controlled group" of organizations, trades, or businesses.[141] This power to reallocate in-

137. "Developing economies" is the more modern term for countries referred to in some literature as "lesser developed countries."

138. *See, e.g.*, *Tax Treaties: Germany Cancels Tax Treaty with Brazil, Gives Transfer Pricing Disputes as Reason*, 13 BNA TAX MGMT. TRANSFER PRICING REP., Apr. 27, 2005, at 1230 [hereinafter *Tax Treaties: Germany*]; *see also* Charles W. Cope & David F. Chan, *An Analysis of the New Japan-United States Income Tax Treaty*, 32 TAX NOTES INT'L 1119, 1119 (2003) (noting that the revised tax treaty provides a time limit for making transfer pricing adjustments).

139. Revenue Act, 45 Stat. 791 (1928) (current version at 26 U.S.C. § 482 (1986)). An earlier predecessor of section 482, created in 1921, permitted the IRS to consolidate accounts of related trades or businesses. Dau & Donnelly, *supra* note 79, at 9 n.21. U.S. transfer pricing law now includes not only brief statutory provisions in section 482 of the Internal Revenue Code, but also interpretive regulations. *See, e.g.*, Treas. Reg. § 1.482-4 (as amended in 2006) ("Methods to Determine Taxable Income in Connection with a Transfer of Intangible Property"); 26 U.S.C. § 6662 (2006) (providing penalties for valuation misstatements).

140. *Cf.* Eduardo Baistrocchi, *The Transfer Pricing Problem: The Argentine Experience (1932-1988)*, REVISTA ARGENTINA DE TEORÍA JURÍDICA, Nov. 2000, *available at* http://200.32.4.58/departamentos/derecho/publicaciones/rtj1/pdf/baistrocchi.pdf.

141. "Controlled Group" means the MNEs owned or controlled directly or indirectly by the same interests. Treas. Reg. § 1.482-1(i)(6) (as amended in 2006).

come was created both to prevent the evasion of U.S. taxes and to reflect real income more precisely.[142]

An amendment to U.S. transfer pricing law in 1986 regarding the transfer or license of intangibles required that the income from the transfer or license be "commensurate with the income" produced.[143] The legislative history to this amendment noted that most transfers of high profit IP did not have "comparables," or past market transactions with similar IP which could help establish appropriate prices for the transfers at hand.[144] Often comparables did not exist because the relevant MNE Group's IP was unique.

Transfer pricing enforcement tightened after the United States discovered that most foreign MNEs with subsidiaries in the United States were not paying any U.S. income taxes.[145] Therefore, in the early 1990s, the United States enacted a tougher penalty regime for substantial and gross misvaluation of transfer pricing as well as contemporaneous record keeping requirements.[146] The United States also created a five-part

142. 26 U.S.C. § 482.

143. *Id.* (referencing intangible property defined under 26 U.S.C. § 936(h)(3)(B) (2007)). This amendment added what is more commonly referred to as the "super royalty" provision. In cases in which IP is transferred under an arrangement that covers more than one year, MNEs may be required to make annual adjustments to the royalties. This is consistent with the "commensurate with income" standard added to section 482. Even if the IRS has determined in an earlier year that the amount charged for IP was at arm's-length, the IRS is not prevented from making an adjustment to the amount in a subsequent year. Treas. Reg. § 1.482-4(f)(2)(i). Two narrow exceptions to the periodic exception rule exist. Both require written pricing agreements and other specified conditions to apply. *See id.* § 1.482-4(f)(2)(ii).

144. BOOS, *supra* note 3, at 97. The IRS has made few upward adjustments to royalty arrangements because of the super royalty provision. Robert J. Cunningham, *The Future of International Transfer Pricing: Practical and Policy Opportunities Unique to Intellectual Property Foreign Transfer Pricing Audits,* 10 GEO. MASON L. REV. 697, 700 (2002).

145. In a subsequent study, the General Accounting Office (GAO) found that a majority of U.S. subsidiaries of foreign MNEs paid no U.S. income tax over the five-year period 1987-1991. The GAO tepidly concluded that transfer pricing abuse was a possible explanation but that other factors also existed. U.S. GENERAL ACCOUNTING OFFICE, INTERNATIONAL TAXATION, TRANSFER PRICING, AND INFORMATION ON NONPAYMENT OF TAX 3 (1995)

146. *See generally* Thomas C. Pearson & Dennis R. Schmidt, *Information Reporting, Record Maintenance, and Transfer Pricing Audits of Foreign and Foreign-Owned Corporations,* TAXES, Mar. 1991, at 172.

strategy to combat improper transfer prices: (1) improve the legal transfer pricing guidance; (2) promote compliance with the legal guidance; (3) strengthen international consensus;[147] (4) encourage early resolution of transfer pricing issues through "Advance Pricing Agreements";[148] and (5) strategically manage transfer pricing litigation.[149]

After the United States enacted transfer pricing documentation requirements and penalties for noncompliance, transfer pricing regimes exploded worldwide.[150] By 2005, over forty countries had enacted statutory laws and regulations governing transfer pricing.[151] This global development resulted primarily from a fear that the United States was forcing MNE Groups to err on the side of attributing too much income to

147. International consensus in tax has been slowly acquired by working with various international organizations. They include the OECD's Committee on Fiscal Affairs' Forum on Tax Administration, the Central Inter-American Center of Tax Administrations, the Pacific Association of Tax Administrators (United States, Canada, Japan, and Australia), and the Group of Four (United States, Germany, France, and United Kingdom). *See* IRS, REPORT § 482, *supra* note 126, at app. A. (charting the average annual section 482 gross tax gap).

148. "Advance pricing agreements" (APAs) provide a government's advance approval as to the MNE's transfer pricing by determining the appropriate transfer pricing method, comparables, and critical assumptions for the APA's duration. OECD Guidelines, *supra* note 1, at G-1.

149. IRS, REPORT § 482, *supra* note 126, at ch. 2(I)(D) (stating the five-part strategy to improve administration of section 482).

150. *See generally* ERNST & YOUNG, 2005-2006 GLOBAL TRANSFER PRICING SURVEYS: GLOBAL TRANSFER PRICING TRENDS, PRACTICES, AND ANALYSES 5 (2005), *available at* http://www.ey.com/global/download.nsf/International/Transfer_Pricing_Global_Surveys_Q4_2005/$file/GlobalTPSurvey_Q4_2005.pdf [hereinafter ERNST & YOUNG, 2005 GLOBAL TRANSFER PRICING TRENDS] (listing in table 3 those countries that have effective documentation rules).

151. DELOITTE TOUCHE TOHMATSU, STRATEGY MATRIX FOR GLOBAL TRANSFER PRICING: PLANNING FOR METHODS, DOCUMENTATION, PENALTIES AND OTHER ISSUES 4-7 (8th ed. 2006). Russia and Sweden are two countries with statutory laws on transfer pricing, but no regulations. *Id.* For baseline information on worldwide transfer pricing law, regulations, rulings, and other aspects of transfer pricing, see ERNST & YOUNG, TRANSFER PRICING GLOBAL REFERENCE GUIDE (2006), *available at* http://www.ey.com/global/download.nsf/New_Zealand/Global_Transfer_Pricing_Reference_Guide_-_Feb_06/$file/GlobalTPGuide_Feb06.pdf.

the United States and away from the activities conducted by MNEs in their own countries.[152]

2. *Worldwide Expansion of Transfer Pricing Regulation*

The first wave of countries after the United States to enact transfer pricing regimes consisted primarily of OECD countries such as Australia, Canada, Korea, and the United Kingdom.[153] The growth in transfer pricing regulation was furthered by the issuance of the OECD Guidelines in 1995.[154] The OECD Guidelines even became secondary legal authority on transfer pricing for many non-OECD countries such as South Africa[155] and Venezuela.[156]

The explosive growth of transfer pricing worldwide is shown by the increasing number of "developing economies"[157] establishing or considering transfer pricing regulation. Several developing economies have adopted statutory laws governing transfer pricing (e.g., Namibia)[158] or transfer pricing

152. *See* Cunningham, *supra* note 144, at 699; *see, e.g.*, Ichira Otsuka, *Japan and U.S. in Transfer Pricing War*, INT'L TAX REV., July/August 1994, at 9 ("Additional taxes imposed this year on Coca-Cola (Japan) and Ceiba-Geigy (Japan) have highlighted an increasing transfer pricing war between Japanese and U.S. tax authorities.").

153. Gregory J. Ossi et al., *The Search for Consistency: A Global Approach to Transfer Pricing Documentation*, TAX MGMT. INT'L J., June 13, 2003, at 283, 288. The transfer pricing rules in these first wave countries were often later articulated in the countries' administrative regulations. *See, e.g.*, Austl. Tax Rul. 94/14; Can. Info. Cir. 87-2R (Sept. 27, 1999), *replacing* Can. Info. Cir. 87-2 (Feb. 27, 1987).

154. The OECD Guidelines are similar to the original 1968 U.S. transfer pricing regulations, prioritizing preferred transfer pricing methods. *See* OECD Guidelines, *supra* note 1, at II-17, ¶ 2.49.

155. Press Release, Deloitte South Africa, Do You Need a Transfer Pricing Policy Document? (Oct. 18, 2006), *available at* http://www.deloitte.com/dtt/press_release/0,1014,sid%253D23596%2526cid%253D135642,00.html (explaining that OECD Guidelines are followed in the absence of specific guidance by South African authorities).

156. Manuel Candal, *Venezuela's New Transfer Pricing Regime in Place for 2003 Filing Season*, 29 TAX NOTES INT'L 1149, 1150, 1152 (2003).

157. *See supra* note 137 (discussing this terminology in more detail).

158. *See* Mark Freer and Gerda Brand, *New Transfer Pricing, Thin Capitalization Rules Take Effect*, 39 TAX NOTES INT'L 1155, 1155-1156 (2005). Since Namibia imposes a higher tax rate than neighboring South Africa or Botswana, parent corporation MNEs located in these neighboring countries often impose a management fee based on net profits of the Namibian subsidiary MNE. This management fee siphons off the MNE's tax base for

regulations (e.g., Egypt).[159] Even more developing economies are on the verge of adopting transfer pricing laws (e.g., Bolivia and Uruguay).[160] Other developing economies addressed transfer pricing concerns under anti-avoidance laws even before transfer pricing regulations were adopted (e.g., Malaysia).[161] Even in countries where no workable transfer pricing rules exist, government tax officials have made an issue of transfer prices using their own judgment (e.g., the Philippines).[162]

To help enforce the transfer pricing laws and regulations, developing economies are enhancing the transfer pricing reporting requirements, increasing potential penalties, and enacting other enforcement measures. Some developing economies are enhancing the evidence required for transfer pricing decisions by MNE Groups (e.g., Pakistan).[163] However, a com-

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Namibia. *See* Cameron Kotze, *What Is Transfer Pricing*, NAMIBIAN, May 10, 2005, http://www.namibian.com.na/2005/May/marketplace/05AEFA69D9.html.

159. *See* Jonathan Rickman, *Transfer Pricing, Thin Cap Regs to Follow OECD Models*, 40 TAX NOTES INT'L 23, 23 (2005) (discussing Egyptian transfer pricing regulations).

160. *See The Year Ahead: As Cost Sharing, Services Dominate U.S. Focus, Smaller Nations Begin Full-Fledged Transfer Pricing Enforcement*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 979 (2005) (discussing Bolivia); Alberto Varela, *Uruguay: Tax Reform Proposal Preserves Source-Based Taxation*, 43 TAX NOTES INT'L 976, 976 (Sept. 11, 2006) (discussing the impending imposition of transfer pricing provisions in Uruguay).

161. Malaysia adopted transfer pricing regulations in 2003. *Malaysia: Revenue Issues First Guidelines Covering Methods, Documents, Arm's-length Principle*, 11 BNA TAX MGMT. TRANSFER PRICING REP. 529 (2003); *Malaysia*, 13 BNA TAX MGMT. TRANSFER PRICING REP. S-19 (Jan. 19, 2005).

162. *See* Dick Du-Baladad, *Let's Talk Tax*, BUSINESS WORLD, Jan. 11, 2005, at 1 (discussing the fact that the Philippines has not adequately addressed transfer pricing concerns).

163. *See* Staff Report, *SECP Issues New Rules on Transfer Pricing*, DAILY TIMES (Pakistan), Jan. 23, 2003, *available at* http://dailytimes.com.pk/default.asp?page=story_23-1-2003_pg5_16. In contrast, in 1994, only two countries (the United States and Australia) had effective documentation rules through specific legislation or regulations requiring transfer pricing documentation. Every three years since then, the number of countries with effective documentation rules has more than doubled. In 2005, at least thirty-two countries had effective documentation rules. ERNST & YOUNG, 2005 GLOBAL TRANSFER PRICING TRENDS, *supra* note 150, at 5.

Documentation requirements for transfer pricing decisions sometimes require an MNE to attach to its corporate tax return a statement about related-party transactions (e.g., in Indonesia). *See* Hadi Sutano & Dr. Rekan, peting concern exists in many developing economies that rigorous transfer pricing laws and regulation might discourage foreign investment in the particular country. Because the transfer pricing laws in developing economies are sometimes ambiguous (e.g., Kenya)[164] and inconsistently enforced (e.g., China),[165] more effective enforcement will require regulation and enforcement assistance from an international body such as the WTO.

Tax treaties are increasingly influenced by transfer pricing concerns.[166] Revised tax treaties such as the treaty between Japan and the United States take transfer pricing into account.[167] Transfer pricing concerns even influenced Ger-

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Transfer Pricing Developments in Indonesia, INDON. TAX FLASH 1, 1 (2003). Some developing economies have imposed potential penalties for egregious transfer prices (e.g., Argentina). *See* ERNST & YOUNG, 2005-2006 GLOBAL TRANSFER PRICING SURVEYS: TAX AUTHORITY INTERVIEWS, PERSPECTIVES AND REGULATORY CHANGES 18 (2006), *available at* http://www.ey.com/global/content.nsf/International/Transfer_Pricing_Global_survey_2005-2006 (Argentina).

164. *See* Andrew Harris, *Multinationals in Kenya Face Transfer Pricing Uncertainty*, 35 TAX NOTES INT'L 891, 891 (2004).

165. *See Chinese Taxpayers Face Uneven Enforcement, Extended Negotiations with Officials, Practitioners Say*, 8 BNA TAX MGMT. TRANSFER PRICING REP. 247 (2001). *See* Philip Anderson & Joe Chan, *Global Transfer Pricing Update: China*, 37 TAX NOTES INT'L 476, 476 (2005). The results of China's inspection of the 9,400 foreign-funded companies in the Guangzhou province revealed that tax evasion through transfer pricing existed to some extent in nearly all of the MNEs. *Id.*; *see also* Jonathan Hopfner, *China Seen Boosting Enforcement Against Foreign Companies with Continuing Losses*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 1030 (2006). *See generally* Amended Taxation Administration Rules for Business Transactions Between Associated Enterprises (Guo Shui Fa [2004] No. 143) (Oct. 22, 2004) (revising transfer prices); James Morgan, *Transfer Pricing in China: Harmonization and Practice*, 15 BNA TAX MGMT. TRANSFER PRICING REP. S-3 (June 21, 2006).

166. India and Italy have amended their tax treaty to include a provision that facilitates the sharing of any transfer pricing adjustment by one country affecting the other country. Sanjay Sanghvi, *India to Sign Protocol Amending Tax Treaty with Italy*, 40 TAX NOTES INT'L 610, 610 (2005).

167. Charles Cope & David F. Chan, *An Analysis of the New Japan-United States Income Tax Treaty*, 32 TAX NOTES INT'L 1119, 1119 (2003) (the revised tax treaty provides a time limit provided for making transfer pricing adjustments). Transfer pricing concerns in Japan extend beyond the U.S. treatment of Japanese MNE Groups. For example, Japan imposed transfer pricing adjustments on MNE Group Suzuki in connection with its subsidiaries in South Africa, Colombia, Hungary, and Indonesia. *See Japan Expanding Transfer Pricing Probes*, 12 BNA TAX MGMT. TRANSFER PRICING REP. 522 (2003).

many's decision in 2005 to give notice to Brazil of termination of their bilateral tax treaty.[168] Because transfer pricing audits of large MNEs are so important, a government's tax treaty personnel are often brought into the process of negotiating agreements with MNE Groups to ensure the consistency of the transfer pricing approach.[169]

Just as IP law merged with international trade law to form international IP law,[170] it is now time to consider merging transfer pricing regulation for IP with international IP law to create more uniform and sophisticated international transfer pricing regulation. To start this process, governments should have tax treaty negotiators interact with IP treaty negotiators to discuss how international IP registration can assist in the collection of taxes. While a tax policy goal is to acquire a fair share of taxes and prevent abusive tax avoidance, the goal in international IP law is to promote the development of IP, particularly with respect to patents for new inventions. International transfer pricing regulation should consider all of these policy goals. It is possible for both the international IP legal system and governmental tax regimes to adopt these fundamental goals while simultaneously creating a more effective legal system regulating the transfer pricing of IP.

The rapid growth in transfer pricing laws and regulations represents "cross-border diffusion" in the law.[171] This diffusion of transfer pricing regimes arises mostly from the legitimate concern that if a country does not adopt detailed transfer pricing regulation and penalties, MNE Groups will favor attributing income to a related MNE located in a second country that has transfer pricing laws and regulations and vigor-

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168. *Tax Treaties: Germany*, *supra* note 138, at 1230 (noting that Germany contended that Brazil's minimum profit margin requirement for related-party transactions violated the arm's-length principle, distorted risk allocations, and did not reflect an open market). Deductibility of royalties and similar expenses in Brazil is limited to ranges between one and five percent. Napoleao Dagnese & Carlos Eduardo Ayi, *An Approach to Brazilian Transfer Pricing Practice*, 13 BNA TAX MGMT. TRANSFER PRICING REP. 701 (2004).

169. *See* IRS, INTERNAL REVENUE MANUAL § 32.4.1.6 (Aug. 11, 2004) (Negotiation and Approval of Bilateral and Multilateral APAs).

170. *See generally* R. Michael Gadbaw, *Intellectual Property and International Trade: Merger or Marriage of Convenience?*, 22 VAND. J. TRANSN'L L. 223 (1989).

171. *See generally* Lorraine Eden et al., *Standards Across Borders: Crossborder Diffusion of the Arm's Length Standard in North America*, 26 ACCT. ORG. & SOC'Y 1 (2001).

ously enforces them. Through transfer pricing regulation, governments worldwide are attempting to curb potential abusive tax avoidance by MNE Groups engaged in transfer pricing manipulation. However, any effective, fair, and efficient transfer pricing regulation must permit MNEs to use valuation approaches as appropriate transfer pricing methods for IP.

C. *Valuation Approaches for Transfer Pricing of IP*

For tax purposes, governments around the world generally use the "arm's-length standard"[172] as the guiding principle for determining an MNE's true taxable income and appropriate transfer prices.[173] An arm's-length transaction is one where the result is the same as if independent parties had negotiated a price to buy or sell the product.[174] Because the arm's-length standard was created in a simpler world when international trade was dominated by highly visible exchanges of raw materials for finished manufactured goods,[175] it presents problems in today's complex world of transferring IP within the sophisticated, integrated global networks of MNE Groups.[176]

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172. For example, U.S. tax treaties generally contain articles requiring the mutual application of the arm's-length principle to resolve transfer pricing disputes. *See* IRS, REPORT § 482, *supra* note 126, at ch. 5(II). MNEs test arm's-length prices by comparing the results of controlled transactions with the results of uncontrolled taxpayers engaged in comparable transactions under comparable circumstances.

173. *See generally* OECD Guidelines, *supra* note 1, at II-17, ¶ 2.49 (discussing the arm's length principle); *accord* OECD, Model Tax Convention on Income and Capital, art. 9, Jan. 28, 2003, *available at* http://www.oecd.org/dataoecd/50/49/35363840.pdf [hereinafter OECD, Model Tax Convention].

174. *See* OECD, *Comparability, supra* note 4, at 69.

175. *See* Lindsay C. Célestin, The Formulary Approach to the Taxation of Transnational Corporation: A Realistic Alternative? 63-64 (Oct. 2000) (unpublished Ph.D. thesis, Univ. of Sydney) (on file with Univ. of Sydney Library), *available at* http://ses.library.usyd.edu.au/bitstream/2123/846/2/adt-NU20020917.13313802whole.pdf.

176. One of the problems of an arm's-length system is a redundant transfer pricing regime for MNEs. Each government has varied requirements and idiosyncratic preferences that can lead to an increased administrative burden and double taxation. *See, e.g.*, IRS, APA Public Hearings—Written Comments, Ford Motor Company (Feb. 1, 2005), *available at* http://www.irs.gov/pub/irs-apa/ford_motor_company.pdf.

To test whether controlled transactions satisfy the arm's-length standard,[177] MNEs must use an approved transfer pricing method.[178] The transfer pricing method used for IP should reflect the modern commercial reality that several patents or other IP are almost always bundled together in one license.

One type of transfer pricing approach is the transactional approach.[179] The transactional approach examines transfer prices on a transaction by transaction basis rather than considering the aggregate financial impact. There are different methods within the transactional approach. The method referred to as the "comparable uncontrolled price" uses a price that an outside party would charge the MNE for the item under similar circumstances.[180] This method is the most commonly used method worldwide to support the transfer prices of IP rights,[181] such as a licensing agreement on a patent.[182]

Comparability is essential for a transactional method to provide a reasonable and reliable benchmark for evaluating an

177. In the United States, the arm's-length price cannot exceed the reported customs valuation. *See* 26 U.S.C. § 1059A (1998).

178. U.S. transfer pricing methods can vary depending on the type of transactions, such as tangible property (Treas. Reg. § 1.482-3 (as amended in 1995)), services (*Id.* § 1.482-9T (as amended in 2006)), and loans (*Id.* § 1.482-2(a) (as amended in 2006)).

179. *See supra* note 6 (outlining the example of Glaxo-Canada's sale of the international licensing rights to a patent to its related-party Glaxo-Ireland). In this example, when the Canadian government made a transfer pricing adjustment of the sales price from $2 to $9, Canada used a transactional approach involving a fantasized third-party sale.

180. The OECD suggests the major traditional transactional method for IP is the comparable uncontrolled price (CUP). *See* OECD Guidelines, *supra* note 1, at II-2 - II-3. Two other traditional transactional approaches to transfer pricing authorized by the OECD are the resale price method and the cost plus method. In practice, these two methods are rarely used for IP because of the uniqueness of most IP. *See* ERNST & YOUNG, TRANSFER PRICING 2003, *supra* note 7, at 18. The OECD Guidelines prefer traditional transactional methods. OECD Guidelines, *supra* note 1, at III-16 - III-17, ¶ 3.49–3.50.

181. The United States has a transactional method similar to the OECD's CUP to determine the appropriate transfer price for IP. The U.S. method is the "comparable uncontrolled transactions" (CUT). However, CUT is rarely used in practice in the United States for the transfer price of IP. *See* Stanley I. Langbein, *Transfer Pricing and the Outsourcing Problem*, 106 TAX NOTES TODAY 1299, 1311 (2005).

182. *See* ERNST & YOUNG, TRANSFER PRICING 2003, *supra* note 7, at 18.

arm's-length result.[183] Finding comparable IP, however, is often difficult or impossible because of the nature of IP itself.[184] Finding comparables for IP is "at best an incomplete exercise and at worst completely subjective."[185] Thus, there is a frequent need to rely on hypothetical transactions in identifying comparable IP for similar products with similar profit potential.[186] Governments sometimes create such fantasy commercial transactions by using comparables not publicly available, known as "secret comparables."[187]

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183. Treas. Reg. § 1.482-1(d)(2) (as amended in 2006). Traditional transactional methods use various factors to determine comparable circumstances for arm's-length consideration, such as the prevailing industry earnings rate and contractual terms for the transfer of any IP rights. *Id.* § 1.482-4(c)(2)(iii)(B)(2) (as amended in 2006). Commercial practices, economic principles, or proper statistical analyses provide a basis to adjust for material differences between controlled and uncontrolled transactions. *Id.* As an example, the European Union expects a comparability analysis to include a description of the property or services, functional analysis, contractual terms, economic circumstances, and specific business strategies. *See* Council Resolution 9738/06, annex ¶ 5.2(c), 2006 O.C. (405) 5 (EU).

184. Treas. Reg. § 1.482-4(c)(2)(iii)(B)(2). "Comparable circumstances" depends on the terms of the transfer, such as the exclusivity, restrictions, and geographic limitations. It also depends on the stage of development of the intangible, such as governmental approvals, authorizations, or licenses. Other factors determining comparables include the rights to future improvements of the intangible, its uniqueness, the period for legal protection, the duration of the license, termination or renegotiation rights, risks assumed by the transferee, and other factors. *Id.*

185. Martin Przysuski, *Transactional Profit Methods: A Practitioner's Response to the OECD,* 43 TAX NOTES INT'L 725, 728 (2006). Transactional methods are particularly difficult to apply to unique IP that is bundled with various other IP.

186. Similar profit potential is measured by the net present value of the benefits (profits and cost savings). The net present value is calculated after considering the capital investment, required startup expenses, risks assumed, and other considerations. Treas. Reg. § 1.482-4(c)(2)(iii)(B)(ii).

187. A Government's use of "secret comparables" is a controversial practice that undermines the transparency in the country's tax law. However, many governments, such as those of Japan, Canada, Korea, and Mexico, use secret comparables to prevent abusive tax avoidance through transfer pricing manipulation. *See, e.g.*, Martin Przysuski, *Canada Reaffirms Use of Third-Party Information for Transfer Pricing Audits,* 34 TAX NOTES INT'L 205, 205 (2004). France, China, Germany, and India have also used secret comparables. Lubna Kably, *Taxmen Flash "Secret Data" to Challenge Companies' Pricing Claims*, ECON. TIMES (India), Nov. 3, 2004, *available at* http://economictimes.indiatimes.com/articleshowarchive.cms?msid=908618. *See generally Re-*

Another type of transfer pricing approach is the valuation approach. The valuation approaches to transfer pricing best satisfy the arm's-length standard for transfer prices of IP and most closely resemble realistic commercial practices in transferring IP. The valuation approaches for IP based on net worth appear less susceptible to transfer pricing manipulation than traditional transactional approaches.

Various valuation methods exist to determine the transfer pricing of IP, as shown in the U.S. transfer pricing regulations for IP.[188] The "comparable profits measure"[189] determines the arm's-length price of a controlled transaction by reference to profit level indicators[190] such as financial ratios from transactions in the same industry.[191] In contrast, the "profits split method"[192] looks at the combined profit or loss from a busi-

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vised Rules Allow Limited TNMM Use, Continue Application of Secret Comparables, 14 BNA TAX MGMT. TRANSFER PRICING REP. 94 (2005).

188. For most MNEs that transfer U.S.-based IP, the valuation issue is the major concern because valuation misstatement penalties may exist. *See, e.g.*, 26 U.S.C. § 6662(e)(1)(B) (2006) (20% valuation penalty).

189. The "comparable profits method" (CPM) is a frequently used valuation approach. IRS, APA STUDY GUIDE 11, *available at* http://www.irs.gov/pub/irs-apa/apa_study_guide_.pdf. Use of the CPM in APAs arises for three major reasons. First, reliable public data on business activities is more generally available than transactional data. Second, the CPM is less sensitive than other methods to differences in accounting practices. Third, less functional comparability is needed to obtain a reliable result under CPM. 2005-1 C.B. 918, 934.

190. While an economist makes numerous adjustments to establish a CPM, there are three different ways to calculate the CPM in the United States: (1) the "CPM with Berry Ratio" (gross profit to operating expenses), (2) the "CPM using an Operating Margin," and (3) the "CPM using a Three-Year Rolling Average Operating Margin." 2006-1 C.B. 779, 805.

191. Treas. Reg. § 1.482-5(a), (b)(4) (as amended in 2003). Comparability under the CPM is less strict than other methods, resting primarily on resources employed and risks assumed. *Id.* § 1.482-5(c)(2). *See generally* Anthony Barbera & John Hatch, *CPM and Determining Income Attributable to Intangible Assets,* 13 BNA TAX MGMT. TRANSFER PRICING REP. 40 (2004). Significant product diversity and functional diversity of the MNE activities for the product are accepted under the CPM. Usually a government prefers that comparable parties operate within the same industry segment as the controlled party. Treas. Reg. § 1.482-5(e)(Ex. 1)(iii). Adjusting for differences in accounts receivable or payable are examples of accounting adjustments to ensure greater consistency for comparability. *See, e.g.*, *id.* § 1.482-5(e)(Ex. 5, 6).

192. The U.S. regulations refer to the "Residual Profit Split Method" (RPSM). Treas. Reg. § 1.482-6(c)(3) (as amended in 2006). The RSPM es-

ness activity between controlled parties[193] and allocates it between the related parties based on a preset formula.[194] Under U.S. law, valuation methods other than these two are permitted only if the alternate method provides the most reliable measure[195] of an arm's-length result.[196]

Valuation approaches are needed for regulating transfer pricing of IP because the value of IP is difficult to measure on

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sentially allocates income based on IP development costs and is widely used in transfer pricing studies for MNEs. *See* Langbein, *supra* note 181, at 1313. Concern exists about the heavily-weighted use of the RSPM in the proposed 2003 regulations. Michael Heimert, *A Systematic Approach to IP Transfer Pricing*, INT'L TAX REV., Jan. 14, 2005, at 37, 39.

193. Treas. Reg. § 1.482-6(a). *See generally* Thomas Horst, *Profit Split Methods*, 60 TAX NOTES TODAY 335 (1993).

194. The formulary apportionment allocation may be based on the relative value of each party's business activity for the combined venture. Treas. Reg. § 1.482-6(b).

195. Reliability of the measurement is based on professional judgment. *See id.* § 1.482-1(c)(1) (as amended in 2006).

196. *Id.* § 1.482-4(d)(1) (as amended in 2006). Other valuation methods consider other evidence of profits. One method uses discounted cash flows expected from the future stream of income from any license rights relating to the patent. *Id.* § 1.482-4(a). *See generally* Jeffrey D. Cole, *A Residual DCF Approach to Valuing Forgone Profits*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 67 (2005). Another valuation method for the transfer pricing of IP includes obtaining external offers on the IP. *See* OECD Guidelines, *supra* note 1, at VI-9, ¶ 6.23. A third method adjusts transfer prices based on the MNE's stock market values, referred to as the "market capitalization residual amount" (MCRM). The MCRM assumes that all of the underlying assets of an MNE are equal to the worth of the MNE's stock. Christopher J. Faiferlick et al., *Planning for Transfers of U.S. Based Intellectual Property to Related Entities*, 96 J. TAX'N 359, 360. The IRS has used the MCRM to propose transfer pricing audit adjustments, particularly when valuing pre-existing IP. *Id.* at 361-62. The IRS's use of the MCRM to determine the arm's-length value of IP in an MNE Group's cost sharing arrangement led the IRS to propose new cost sharing regulations in September 2005, based on a new "investor model" for inter-company cost sharing. *See generally* David L. Forst et al., *IRS Likely to Modify Current Cost-Sharing Regulations with 'Investor Model' Transfer Pricing Method*, 102 J. TAX'N 57, 57 (noting that the "investor model," as illustrated in the context of software IP, distinguishes between (1) rights to make and sell existing products using the software and (2) using the rights in research activities under a qualified cost sharing agreement); Keith Reams et al., *Proposed U.S. Cost-Sharing Regulations: Are They a Realistic Alternative*, 40 TAX NOTES INT'L 269 (2005).

a transaction by transaction basis.[197] However, the OECD Guidelines disfavor use of a valuation method for IP,[198] indicating that the Guidelines need substantial updating to reflect modern commercial realities. The OECD and the countries that rely on the OECD Guidelines should include all appropriate transfer pricing methods for valuing IP. The OECD should authorize transfer pricing methods similar to the valuation methods approved in the United States to obtain more accurate transfer prices and to reduce abusive tax avoidance.[199] The governing standard for transfer pricing methods in the United States is the "best method rule,"[200] which utilizes

197. *See, e.g.*, Vinay Kapoor & Kurt J. Regelbrugge, *Cost Sharing: Valuing Intangible Platform Rights in IP Transfers*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 141 (2005).

198. The OECD Guidelines provide two valuation approaches for IP. The major OECD valuation approach to transfer pricing is the "Transactional Net Margin Method" (TNMM). OECD Guidelines, *supra* note 1, at III-9, ¶ 3.26. The TNMM is an indirect method whereby the operating profit is generally related to sales, costs, or net assets. *Id.* The other OECD valuation approach is the "Profit Split" method. *Id.* at III-17, ¶ 3.50. The OECD Guidelines appear to effectively discourage use of the profits split method except as a check on the reasonableness of the results from another method. *Id.* ¶ 3.52. While most countries follow the OECD Guidelines on transfer pricing methods, three countries are even more antiquated insofar as they permit only the transactional methods for transfer pricing and not the profits split methods. DELOITTE TOUCHE TOHMATSU, *supra* note 151, at 8-9 (noting that Chile, Kazakhstan, and Russia still permit only transactional approaches to transfer pricing). Vietnam updated its transfer pricing approaches in 2006. Deloitte, *Vietnam Issues Circular on Transfer Pricing Regulation*, ARM'S LENGTH STANDARD, Apr. 2006, at 1, *available at* http://www.deloitte.com/dtt/cda/doc/content/dtt_tax_tals_170406.pdf.

199. *See* Mitchell J. Tropin, *OECD Seeks Comments on Applying Profits-Based Methods, Method Hierarchy*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 904 (2006).

200. The United States has required MNEs to apply the "best method rule" for testing the arm's-length character of a controlled transaction. The best method rule is the method which provides the most reliable measure for an arm's-length result, or a range of acceptable arm's-length prices, based on the facts and circumstances. Treas. Reg. § 1.482-1(e)(2)(iii)(B) (as amended in 2006). In selecting the best method, MNEs should document the relative value of the economic contribution of the controlled party to the combined business activity. Then, they should analyze the functions performed, risks assumed, and resources employed by each party. *Id.* § 1.482-1(c)(2). Relevant factors to determine the best method include the quality of the data and the degree of comparability between controlled and uncontrolled transactions. The assumptions used in the analysis and the extent of adjustments necessary to apply each method are also important. *Id.*

various criteria, such as the requirement that data be comparable and reliable, to evaluate the valuation methods.[201]

Looking more broadly at the policymaking level for authorizing transfer pricing methods, it is helpful to consider the general framework of "internationalization" of a commercial concern. The first stage encourages international cooperation to exchange information, as is illustrated by government discussions on transfer pricing. Often the second stage creates mechanisms for resolving international disputes, as has occurred with the WTO and international IP law.[202] A third stage attempts to harmonize definitions and provisions in an area of law, such as patent law.[203] A fourth stage subordinates national law to review or potential pre-emption by an international body.[204] A fifth stage permits jointly-created international law to govern within a country, such as the creation of an EU directive or regulation.[205]

The rationale for adjusting the tested comparables should depend on commercial practices, economic principles, or statistical analysis. *Id.* § 1.482-1(d)(2).

201. Sources on external comparables arise from (1) confidential information from third parties often referred to as secret comparables, (2) public information such as industry surveys, and (3) databases that compile information supplied by the MNEs. *See* OECD, *Comparability, supra* note 4, at 23. Comparables are usually located using public databases. *See generally* Mildred A. Hastbacka, *Valuation of Technology Intangibles for Transfer Pricing: Time for Industry Initiatives?*, 32 TAX NOTES INT'L 265, 272 (2003).

202. The WTO has the WTO Appellate Body, which oversees the work of all WTO dispute resolution panels. *See* G. Richard Shell, *Trade Legalism and International Relations Theory: An Analysis of the WTO,* 44 DUKE L.J. 829, 831-34, 848-53 (1995).

203. Because patent laws vary among countries, WIPO worked in 2005 on further patent law harmonization. *See* News Release, U.S. Patent and Trade Office, Patent Law Harmonization Talks Stall: Brazil, Argentina, India Oppose Compromise (June 14, 2005), *available at* http://www.uspto.gov/main/homepagenews/bak2005jun14.htm.

204. An example of subordination of national law is U.K. law on transfer pricing needing to comply with European Union law. After the European Court of Justice (ECJ) review of U.K. transfer pricing law in 2004, the U.K. expanded its transfer pricing legislation to apply domestically and not discriminate against nonresidents who are EU residents. *See* Press Release, PriceWaterhouseCoopers, UK Government Acts in Response to Challenges under EU Law: Changes Proposed to UK Transfer Pricing and Thin Capitalization Rules (on file with author).

205. *See, e.g.*, Commission Regulation 707/2004, 2004 O.J. (L 111) 3 (EC) (amending EC Regulation 1725/2003 and adopting certain international ac-

This Note advocates advancing transfer pricing for IP from the first stage to the second and third stages of international development. Furthermore, the OECD's ineffectiveness in the tax area leads me to believe that governments could use the IP framework existing in the WTO to redefine the appropriate transfer pricing methods for IP based on valuation. While advancing to the fourth and fifth stages of internationalization may be appropriate for regional blocs such as the European Union, such development is not desirable more broadly because of significant differences that persist in commercial sophistication, transfer pricing regulation, and the legal/economic environment.

IV. Proposed Legal Reforms to Reduce Abusive Tax Avoidance

Governmental transfer pricing regulations worldwide have not only lagged behind the transformation of MNE Groups into global or regional organizations of complex integrated networks, but they have also trailed the development of abusive tax avoidance schemes employed by MNE Groups. These lags are especially evident in the transfer pricing regulation of IP.[206] Abusive tax avoidance schemes by MNE Groups often involve complex ownership transactions and other maneuvers that attempt to disguise the real economic value of income-producing IP. As I have discussed, governments are no longer able to rely on the validity of standard commercial practices when such practices reflect the widespread tax avoidance tactics commonly used by MNE Groups. Furthermore,

counting standards in accordance with EC Regulation No. 1606/2002 of the European Parliament and of the Council).

206. PriceWaterhouseCoopers refers to the MNE Group transformation as "Value Chain Transformation" for "Global Structure Alignment." PriceWaterhouseCoopers, London, OECD Roundtable, Why Are Companies Changing Their Business Operating Models (Jan. 26–27, 2005) (on file with the New York University Journal of International Law and Politics); PriceWaterhouseCoopers, Value Chain Transformation/Global Structure Alignment, http://www.pwc.com/extweb/service.nsf/docid/ea58bc7e5fd9f86b85 256fd50049c4a3 (last visited Feb. 7, 2008). Deloitte refers to this as "Supply Chain Management." Ron Haigh & John Henshall, Presentation at the OECD's Roundtable on Business Restructuring: Business Restructurings—A View from a Professional Services Firm 2 (Jan. 26–27, 2005). The idea is to share information both within the business and with customers and suppliers in order to optimize all aspects of a "just in time" approach. *Id.*

traditional transfer pricing rules as applied to IP need further refinement to enable governments to prevent MNE Groups from skimming profits away from their operations in higher-tax countries. Thus, abusive tax avoidance through transfer pricing manipulation of IP, along with the recent movement of IP to tax haven countries, has created a pressing need for legal reforms in IP transfer pricing regulation.

This Note proposes three major international legal reforms to more effectively reduce abusive tax avoidance by MNE Groups. The first proposal is to incorporate a minimum tax into the current international treaties on IP registration to prevent MNE Groups from escaping significant tax on their IP. The second proposal is to adopt uniform and all-inclusive multiple ownership rules for IP to identify the MNEs rightfully subject to taxation as IP owners. The third proposal is to apply formulary apportionment to determine the amount of income from IP allocable to these MNEs.

A. *Using Treaties for IP Registration to Impose a Minimum Tax on IP*

Incorporating a minimum tax into the current international IP registration system could ensure that MNE Groups pay an appropriate amount of tax on their IP.[207] Currently, multilateral international IP law provides a comprehensive worldwide IP registration system.[208] However, there is no analogous worldwide structure for transfer pricing. No tax treaties exist that regulate the transfer pricing of IP globally. Tax treaties are predominately bilateral, and only a few treaties contain transfer pricing provisions. If a proper fee structure based on the value of IP were put in place within the IP registration system, it would essentially function as a minimum tax on MNE Groups' IP. Consequently, the IP registration system could serve as an effective and all-encompassing means for taxing IP for its real underlying economic value worldwide.[209]

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207. A credit for taxes already paid by the MNEs on the IP would mitigate potential double taxation on MNEs. To implement this, the IP registration system would collect information on the taxes paid worldwide related to a particular IP.

208. *See supra* Part II.A.

209. An international agreement could achieve the goal of preserving each country's tax base by preventing MNEs from removing much of the IP from their tax base. This goal would be achieved while still achieving the tax

The present international IP registration system collects information on IP worldwide, charges nominal administrative fees,[210] and in return provides legal protection for registered IP.[211] It is not good public policy to give MNE Groups substantial legal protection under this registration system[212] and yet allow them to engage in abusive tax avoidance. Thus, it would be appropriate to raise the rates of the administrative fees[213] and shift the fee structure to a sliding scale based on the value of the IP. This would recover revenues from IP that currently escape taxation.[214]

To incorporate the minimum tax into the international IP registration system would require collaboration by various multilateral trade organizations.[215] Using the WTO regime to

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policy goal of eliminating double taxation and the non-tax policy goal of promoting IP for further innovation and/or customer protection.

210. Currently, the IP registration fees are nominal and merely cover the government office's basic costs. A sliding scale of fees for patents is used only to a limited extent, ranging from several hundred dollars to a few thousand, based primarily on the age of the IP. *See* 35 U.S.C. § 41(b) (2002).

211. *Cf.* Figueroa v. United States, 466 F.3d 1023, 1030-31 (Fed. Cir. 2006) (asserting that Congress may constitutionally impose patent fees in excess of the amount needed to fund the Patent and Trademark Office).

212. The registration system could also collect tax data on other taxes paid relating to the IP. The amount of other taxes paid could impact the size of the fees collected under the registration system.

213. Higher patent fees would also help solve the serious backlog problem that exists in patent offices not only in the United States but in many parts of the world. *See* Federico Aulmann, *INPI Acts Over Patent Backlog*, MANAGING INTELL. PROP., Dec. 1, 2004, at 76.

214. An increase in patent fees would also help reduce the number of trivial patent applications having very limited potential value that are currently overwhelming the patent system. Fewer applications should enable patent offices to return to a focus on patents providing real innovations and help process patent applications more quickly. *See generally* AMERICAN INTELLECTUAL PROPERTY LAW ASSOCIATION (AIPLA), AIPLA RESPONSE TO THE NATIONAL ACADEMIES REPORT ENTITLED "A PATENT SYSTEM FOR THE 21ST CENTURY," *available at* http://www.aipla.org/Content/ContentGroups/Issues_and_Advocacy/Comments2/Patent_and_Trademark_Office/2004/NAS092304.pdf.

215. For instance, the OECD, which establishes guidelines on international trade issues, could assist in drafting the substantive multilateral treaty provisions. WIPO, which administers the international IP registration system on behalf of the WTO, could incorporate the new provisions into international IP law. The WTO, as the ultimate organization overseeing international IP law, would then be positioned to undertake the enforcement responsibilities.

address abusive tax avoidance is probably the most effective route for long-term solutions because the WTO grants or revokes member countries' normal trading relations status based on their compliance with WTO requirements.[216]

1. *Adopting Uniform Multiple Ownership Rules for IP*

Identifying the appropriate parties subject to tax for income generated from IP is a critical concern for the transfer pricing regulation of IP. In the international context, ownership rules for IP determine to which MNE profits arising from the IP are attributed for tax purposes. Thus, the ownership rules affect the amount of taxes any government could potentially collect from an MNE. The development and income-producing activities of IP are generally undertaken by MNE Groups throughout the world. Multiple MNEs within MNE Groups may play the roles of the legal owners, the primary or secondary developers, the distributors, or the marketing agents of the IP.

Different ownership rules for IP exist in different countries. The most comprehensive model is the U.S. "developer-assister" rules,[217] which consider three major means of owner-

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Currently, the International Monetary Fund (IMF) and World Bank provide some assistance in promoting discussion between countries for a potential coordinated worldwide approach in economic/legal policies on transfer pricing of IP. *See* Staffs of the IMF, OECD, and World Bank, Developing the International Dialogue on Taxation, http://www.imf.org/external/np/fad/itd/2002/031302.htm (last visited Jan. 15, 2008). It helps to have these international bodies promote the review of existing transfer pricing standards and valuation methods. BOOS, *supra* note 3, at 229; *see also* Staffs of the IMF, OECD, and World Bank, *supra*.

Similarly, the OECD held its first joint conference with the World Customs Organization in 2006 to discuss how transfer pricing impacts customs administration and customs policies influence transfer pricing regulation. *See* World Customs Organization, WCO/OECD Conference on Transfer Pricing and Customs Valuation, http://www.wcoomd.org/event_cal2006_val factsheet.htm (last visited Jan. 26, 2008).

216. All jurisdictions where IP receives legal protection should have the ability to tax the IP used in the jurisdiction to generate income. Any country's failure to join in the treaty could make the country less attractive to foreign investment. *See, e.g.*, ERNST & YOUNG, TRANSFER PRICING 2003, *supra* note 7, at 49 (describing Ireland's Fiscal Authority Approach).

217. The "developer-assister" rules in transfer pricing regulations determine which parties should benefit from the IP profits. Developer-assister rules enable a party who contributed to the development or enhancement of

ship: legal ownership, economic ownership, and cost-sharing ownership.[218] Other models generally consider only one of these three means of ownership.

Some countries look to legal ownership alone in attributing ownership of IP for tax purposes.[219] Legal ownership of IP could be an appropriate basis for attributing income from IP.[220] An owner of a patent who took enormous risk in developing the innovation underlying the patent deserves some financial reward from the now income-generating patent. Legal ownership of IP, however, is highly susceptible to abusive tax avoidance schemes. MNE Groups commonly move the legal ownership of their IP to tax haven MNEs that took little or no part in the development of the IP. For this reason, legal ownership should not be the sole basis for attributing income from IP.[221]

IP legally owned by another party to become a beneficial owner of the IP. Treas. Reg. § 1.482-4(f)(3) (as amended in 2006). Previously, under the old 1968 regulations, ownership was attributed for tax purposes based on the economics of the IP's development. *Id.* § 1.482-2(d)(1)(ii)(C) (as amended in 2006), *reprinted in DHL v. Comm'r*, 285 F.3d 1210, 1221 (9th Cir. 2002); *see infra* note 224 (discussing *DHL*). While four factors were used under the 1968 regulations, greatest weight was given to the first factor which considered the relative costs and risks borne by each party. *See* Am. Bar Ass'n Comm. on Transfer Pricing, *Important Developments During the Year: Transfer Pricing*, 56 TAX LAWYER 1201, 1203 (2003).

218. For example, Canadian tax authority expects a higher rate of return from the IP owner for distributors with marketing costs exceeding those of other "arm's-length distributors" with similar rights to exploit the IP. A distributor's yearly marketing activities should receive significant weight in evaluating the return attributable to the marketing activities. International Transfer Pricing, Info. Cir. 87-2R ¶ 148, (Sept. 27, 1999) (Can).

219. T.D. 9278, 2006-34 I.R.B. 256, 267 ("After considering the public comments, the Treasury Department and the IRS conclude that legal ownership provides the appropriate framework for determining ownership of intangibles under section 482.).

220. Even if the income is allocated to the legal owner, significant transfer pricing disputes will continue to exist between MNEs and government tax authorities in the absence of a globally unified definition of ownership.

221. In 2003, the United States made the mistake of proposing to change its regulations in determining ownership under the U.S. "developer-assister" rules to consider only the "legal ownership" for IP. The 2003 U.S. proposed regulations on embedded IP had two major goals: (1) to respond to the heavy criticism of the developer-assister rules that are inconsistent with IP law and (2) to prevent abuse of the current regulation's "all or nothing" result. Prop. Treas. Reg. § 1.482-4(f)(3)-(4), 68 Fed. Reg. 53448, 53462-64 (Sept. 10, 2003).

The OECD's Model Tax Convention only considers economic ownership.[222] Economic ownership[223] can be another appropriate basis for attributing income from IP. For example, an economic owner of a patent may be a marketing agent with licensee rights in a specific country. The economic owner who invested considerable efforts for successful commercial exploitation of the patent deserves some of the financial rewards from the patent. However, using economic ownership as the only means of ownership for attributing income from IP is problematic. Determination of the real economic owner can be very difficult and varies from case to case.[224] Some IP

The major problem with the 2003 proposed regulations on "developer-assister" rules was that they limited the economic rewards to just the legal owner. The legal owner under IP law becomes the sole owner for tax purposes, unless that ownership is inconsistent with the economic substance underlying the transactions. However, distributing all residual profits based on a single factor of ownership, as suggested in the 2003 U.S. proposed regulations, is a poor idea. Allocating "all or nothing" based on ownership would encourage many MNE Groups to manipulate business activities to achieve the desired tax result. The IRS was planning to finalize its proposed regulations governing the transfer pricing of intangibles in the summer of 2007. *See generally* Drew Douglas, *Transfer Pricing Top Priority as IRS Plans Release of International Guidance*, 14 BNA TAX MGMT. TRANSFER PRICING REP. 798 (2006); Langbein, *supra* note 181, at 1313; Elena R. Tsaneva, *Transfer Pricing in the World of Services and Intangibles—A New Challenge to Preserving the Corporate Tax Base*, 9 UCLA J. INT'L L. & FOREIGN AFF. 323 (2004); Leonard Terr, *The Proposed Transfer Pricing Rules*, 101 TAX NOTES TODAY 1439, 1454 (2003) (discussing intangible ownership and value).

222. OECD, Model Tax Convention, *supra* note 173, art. 9(2).

223. "Economic ownership" is based on determining the related party bearing the "key entrepreneurial risk taking functions" for the greatest share of the cost and risks of development of the IP. Martin Przysuski, *Identification, Innovation, and Intangible Ownership in Transfer Pricing*, 42 TAX NOTES INT'L 1139, 1142 (2006).

224. U.S. courts applied the "developer-assister" rules to determine the share of the profits awarded to the MNE conducting marketing activities in DHL v. Comm'r, 76 T.C.M. (CCH) 1122 (1998), 1998 WL 906788, *rev'd,* 285 F.3d 1210 (9th Cir. 2002). DHL and its related foreign subsidiaries (DHLI) were active in the global package delivery business. DHL sold more than fifty percent of the DHL network to DHLI, including the sale and use of the foreign rights to the DHL trademark. DHLI safeguarded the DHL trademark in foreign markets, protected the DHLI name from infringement, bore the associated costs, and registered the trademark in DHLI's own name. Invoking the old 1968 section 482 regulations, the IRS imposed a royalty on DHLI and asserted a larger value ($300 million) for DHL's sale of the IP.

may be highly marketable mainly because of the associated technological breakthrough and not because of any superior marketing efforts. More importantly, IP early in the marketing stage may not yet possess much commercial value beyond the value arising from the original invention of the IP.

Cost-sharing ownership is an appropriate basis for determining transfer prices. Because costs are often shared in developing IP in the integrated networks of many MNE Groups today, MNEs involved with the IP or its commercial products should share the financial awards accordingly.[225] However, cost-sharing ownership should not be the only basis for attributing income from IP, because legal and/or economic owners are at least as important, if not more important, to the commercial success of the IP.

The IRS used the original 1968 U.S. transfer pricing regulations to reallocate income from DHLI to DHL under section 482. The IRS argued that DHL had made a royalty-free license of the IP's foreign rights to DHLl. *Id.* at * 31. DHL responded that DHLI owned the foreign rights to the trademark because of DHLI's efforts to develop the trademark in foreign markets. *Id.* at * 40. DHL asserted its value was $20 million, after its lawyers removed some favorable terms and encumbered the IP with two cross-licensees. Using the developer-assister rules, DHL argued that no section 482 adjustment was appropriate because DHLI developed the DHL IP in the overseas market and owned the foreign rights to the IP.

The Tax Court examined the legal ownership using the "developer-assister" rules from the 1994 transfer pricing regulations. The U.S. Tax Court applied the 1994 regulations and held that because DHL was the legal owner of the IP under substantive principles of IP law, it was entitled to a royalty for the use of the DHL name. *Id.* at * 68. The Tax Court believed that because DHL did not have substantial factual authority for its reporting position on the IP and the royalties, legal ownership would control. *Id.* at * 71. The Ninth Circuit subsequently reversed the Tax Court's decision because the Tax Court erroneously failed to apply the old 1968 regulations. DHL v. Comm'r, 285 F.3d 1210, 1221 (9th Cir. 2002).

Despite the subsequent reversal of its decision, the Tax Court's analysis is essential for understanding future transfer pricing litigation of IP. It is now much easier for the government to reallocate income to the MNE that helps generate income from the IP and win any future complex transfer pricing case on IP. *See generally* Espen Robak, *Son of Solomon: Tax Court Splits the Baby in DHL Corp.*, TAXES, Sept. 1999, at 20.

225. This may be done through cost sharing, cost contribution, or ownership by agreement. Treas. Reg. § 1.482-7 (as amended in 2004). *See generally* Keith Reams et al., *Proposed U.S. Cost-Sharing Regulations: Are They a Realistic Alternative?*, 40 TAX NOTES INT'L 269 (2005) (discussing the philosophical shift in and potential impact of new cost sharing regulations).

While legal, economic, and cost-sharing ownership concepts are all valid, each has flaws if serving as the sole basis for attributing income from IP for tax purposes. This is why the U.S. "developer-assister" rules, encompassing all three means of ownership, constitute a superior model.[226] Without internationally uniform ownership rules for IP, MNE Groups will continue to exploit the inconsistencies in ownership rules for tax avoidance. Thus, this Note advocates a uniform and all-inclusive regulatory framework for ownership rules, such as the "developer-assister" rules, to discourage the aggressive abusive tax avoidance tactics of MNE Groups.[227]

2. *Applying Formulary Apportionment to Allocate Income from IP*

After identifying which MNEs within an MNE Group possess valid ownership under the ownership rules to qualify for some financial return from each income-producing IP right, determining the amount of income attributable to those MNEs is the next important step for transfer pricing regulation of IP. Traditionally, the net income for a particular IP is determined at the MNE level, after separating the income earned by each MNE and its own expenses from those belonging to other related MNEs. However, as illustrated in *Glaxo*, transfer pricing used in determining the income and expenses among related MNEs is among the most egregious areas in transfer pricing manipulation.[228] Thus, this Note advocates the application of "formulary apportionment" [229] on income from IP in order to determine the amount of income attributable to an MNE.[230]

226. The 1994 revision of the U.S. regulations recognized that while the legal owner has the right to exploit IP, a party without legal ownership may have a right to economic return in exchange for developing the IP. Treas. Reg. § 1.482-4(f)(3)(ii)(B) (as amended in 2006).

227. Under my proposal, a broad definition of ownership helps to ensure that governments collect proper revenue from IP attributable to products developed or sold in the country. Potential double tax on MNE Groups may be resolved through treaty provisions or an allocation formula.

228. *See supra* Part III.A (explaining the situation in *Glaxo).*

229. Formulary apportionment has some problems. *See* Charles E. McLure, Jr., *U.S. Federal Use of Formula Apportionment to Tax Income from Intangibles*, 75 TAX NOTES TODAY 109, 109 (1997) (summarizing his 1996 report presented to the U.S. Treasury Department).

230. *See* Michael J. McIntyre, *The Use of Combined Reporting by Nation States,* 35 TAX NOTES INT'L 917, 917 (2004*). See generally* Thomas C. Pearson, *State*

Under formulary apportionment, an MNE Group would not allocate income to its MNEs based upon the geographic location of where the income is earned. Formulary apportionment assumes that some part of each dollar that an MNE earns relates to all of the tax jurisdictions in which the income-producing activities take place.[231] Thus, the MNE Group would first calculate its net income for the IP within the Group and then apportion that income by formula to each MNE with ownership rights to the IP. Determining the net income at the MNE Group level would factor in income and expenses relating to the IP from third parties only, rather than inter-company transactions. This top-down approach would effectively resolve the tax avoidance problem by eliminating the need for transfer prices among related MNEs.

Formulary apportionment within the arm's-length standard framework using a profits split method[232] is a good solu-

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Taxation of Foreign Source Income Through Worldwide Combined Reporting, 17 VAND. J. TRANSNAT'L L. 95, 100 (1984).

231. *See* Michael J. McIntyre, *Contrasting Methodologies: A Systematic Presentation of the Differences Between An Arm's-Length/Source-Rule System and a Combined-Reporting/Formulary-Apportionment System*, *in* NAT'L TAX ASS'N-TAX INST. OF AMERICA, PROCEEDINGS OF THE 87TH ANNUAL CONFERENCE ON TAXATION 226 (1994), *available at* http://www.law.wayne.edu/McIntyre/text/mcintyre_articles/contrasting_method.pdf. Thus, formulary apportionment divides the MNE's income by an apportionment formula. For example, Canadian provinces tax MNEs using a two factor apportionment formula of payroll and sales. Joann Martens Weiner, *Would Introducing Formulary Apportionment in the European Union Be a Dream Come True or the E.U.'s Worst Nightmare?*, 48 INFO STUDIEN: ZEITSCHRIFT FÜR EMPIRISCHE WIRTSCHAFTSFORSCHUNG 519, 524 (2002). A formulary apportionment for IP could reflect three factors: capital, labor, and sales.

232. *See supra* text accompanying notes 192-94 (describing the profits split method). Recall that the most practical transfer pricing method for IP under the arm's-length method is based on a valuation approach, such as a profits split method. Formulary apportionment is already built into the profits split method. Stanley Langbein, a law professor at the University of Miami, has characterized the distinguishing line between the arm's-length standard and some type of formulary apportionment as blurred; the line is really part of a continuum. Langbein, *supra* note 181, at 1301. The reason for the continuum is that transfer pricing methods based on a valuation approach are not only a type of formulary apportionment but also arguably meet the arm's-length standard, which is important for fulfilling current tax treaties since bilateral tax treaties throughout the world require the arm's-length standard for transfer pricing. *See Bilateral Tax Treaties and Protocol: Hearing Before the S. Comm. on Foreign Relations*, 105th Cong. 12 (1997) (state-

tion for allocating income in cases of patents and other IP where complex, globally-interlinked activities cause significant valuation problems.[233] Thus, the EU is experimenting with allowing small-medium-enterprises (SMEs) operating on a regional basis to have their tax bases allocated to the relevant EU countries based on the countries' respective shares of the SMEs' total payrolls. This is a common method of formulary apportionment.[234]

V. Conclusion

As MNE Groups increasingly operate as internationally-integrated networks, they are engaging in aggressive global tax planning to greatly reduce their total tax liabilities worldwide. Some MNE Groups' tax planning strategies have led to abusive tax avoidance schemes. The most egregious tax avoidance has taken place in the transfer pricing manipulation of IP and in the relocation of IP to tax havens. Such abusive tax avoidance has unfairly drained significant tax revenue from many countries and has created an enormous challenge for the global economy.

To address this problem effectively, it is essential for the international community to establish uniform and comprehensive transfer pricing regulations. Thus, this Note proposes

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ment of Joseph H. Guttentag, International Tax Counsel, Dep't of Treasury).

233. This type of a profit split even exists in the transfer pricing regulations for global trading by a global financial company. McLure, *supra* note 229, at 210. *See generally* Thomas C. Pearson & Dennis R. Schmidt, *Transfer Pricing Tax Concerns for Global Financial Companies*, 76 Taxes 23 (1998). A "Global Financial Company," also known as a "global dealing operation," includes the marketing, sales, pricing, and risk management activities of financial transactions in multiple jurisdictions and/or through multiple participants. Treas. Reg. § 1.482-8(a)(2)(i) (as amended in 2006); *see also* OECD, Model Tax Convention, *supra* note 173, art. 9. Factors for apportionment include compensation (representing value for highly skilled personnel), trading volume (representing the level of activity) and "maturity weighted trading volume" (representing investment risk). *See* I.R.S. Notice 94-40, 1994-1 C.B. 351.

234. *See* Joe Kirwin & Mitchell J. Tropin, *EC Proposes Home State SME Pilot; Program Would Use Formulary Apportionment*, 14 BNA Tax Mgmt. Transfer Pricing Rep. 734 (2006). The OECD has authorized formulary apportionment on an experimental small scale. *See European Union: EC to Propose Legislation by Early Fall to Launch SME Home State Tax Pilot Project*, 13 BNA Tax Mgmt. Transfer Pricing Rep. 1099 (2005).

that incorporating a minimum tax into current international treaties on IP registration could prevent MNE Groups from escaping significant tax on income generated from IP. This Note also proposes the adoption of uniform and all-inclusive multiple ownership rules for IP as a way to identify the MNEs within MNE Groups who are the rightful owners of the IP and are thus subject to taxation. Lastly, this Note advocates the use of formulary apportionment to determine the amount of income from IP allocable to these MNEs.

MNE Groups should support these proposed international legal reforms. The assumption underlying most tax systems is that MNEs are good corporate citizens and pay their fair share of taxes. In recent years, MNE Groups have severely undermined their credibility with host countries through adverse publicity about their abusive tax avoidance. If MNE Groups fully comply with this new transfer pricing regulation system and use appropriate transfer prices to reflect the economic realities of their related-party transactions, they could restore some credibility with the public and government regulators. Hopefully, they could preserve a favorable corporate tax and regulatory climate for future international business transactions.[235]

235. For a general discussion of the necessity to regulate MNE Groups for non-tax reasons, see Simon Chesterman, *Oil and Water: Regulating the Behavior of Multinational Corporations Through Law*, 36 N.Y.U. J. INT'L L. & POL. 307 (2004).