

Arbitrage and Transfer Pricing

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Abstract

The past few years have witnessed a lively debate in the United States and some other countries over the acceptability of international tax arbitrage—the deliberate attempt to take advantage of the different tax characterizations that countries may ascribe to a single set of facts. This paper examines one example of arbitrage stemming from differences between US transfer-pricing rules and the rules that other jurisdictions apply to evaluate transfer pricing. The paper asks whether the United States should find a problem in this arbitrage. On the assumption that a problem does exist, the paper goes on to examine what the United States might choose to do about it, given other tax policy considerations.

Perhaps one of the most fundamental issues facing all of us right now is the extent to which cross-border tax arbitrage is appropriate. I don't mean to raise for further consideration whether transactions that can be categorized as abusive cross-border shelters are legitimate. Rather, what I am raising is the somewhat more difficult question of whether arbitrating tax results, in a nonshelter transaction, runs afoul of US tax policy interests.

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In a recent article,² based on a somewhat less recent lecture,³ I maintained that international tax arbitrage is pervasive, unavoidable, and quite possibly unobjectionable as a matter of US tax policy.⁴ The article was intended only to raise, not address, this last point, and of course the debate on arbitrage has barely begun. What is clear, and noted in the article, is that Congressional efforts to deal with arbitrage have been incoherent, that policies articulated by the Treasury and the Internal Revenue Service in regard to arbitrage have been inconsistent, and that outrage directed at parties taking advantage of arbitrage opportunities is misplaced. None of this means, necessarily, that arbitrage should be acceptable to the United States. The subject requires further thought.

In this paper I attempt to pose additional questions by demonstrating, through a single specific example, how arbitrage possibilities can arise as a byproduct of a wholly desirable—or at least arguably wholly desirable—tax policy initiative; that such possibilities are, in other words, inevitable, indeed as common as beach sand and probably just as difficult to eliminate. Further, the discussion below makes clear that persons taking advantage of arbitrage possibilities may be engaging in activities no more questionable than accepting clearly expressed invitations to reduce their tax liabilities, and that threatening penalties for doing this or otherwise attempting to dissuade such persons from employing arbitrage is both fruitless and silly. Moreover, any attempt to “fix” the arbitrage problem is almost assuredly going to carry a cost in terms of other tax policy objectives. Rather than attempting to stop what may well be unstoppable, US policy makers might perhaps expend their energies determining first, and maybe last, whether and why arbitrage is problematic in the first place.

My example is drawn from the realm of transfer pricing, an area in which US officials and the interested public have recently spent over a decade studying, proposing, discussing, and burnishing an extremely fine-tuned set of rules.⁵ And the effort is not yet concluded. Important regulations have been promised but not yet published, dealing with the treatment of income from services and perhaps with other matters. In addition, we have yet to see adjudication interpreting the new rules, since US audit experience lags years behind changes in positive law, and decades may be consumed in the uncertain voyage from audit to court decision.⁶ Nevertheless, what stands on the books at this writing, insofar as transfer pricing is concerned, is an elaborate regulatory scheme adopted after very considerable study, comment, and revision, and presumably with the best of tax policy considerations in mind. Most of the rules in question appear to be salutary, and the provisions focusing on documentation as a means of furthering compliance and reducing the burden on tax administration plainly represent major improvements.

The aspect of the rules on which I propose to focus is an integral part of the final package—it was reviewed, edited, set forth in final regulations—so it is definitely not a temporary provision, an aberration, something likely soon to be “discovered” and changed. This is mature fruit of the US national transfer-pricing review.

If necessary to reflect an arm’s length result, a controlled taxpayer may report on a timely filed US income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged.⁷

The statement is explained as follows in the preamble that accompanied publication of the final regulations:

The provision regarding the taxpayer’s use of section 482 (section 1.482-1(a)(3)) has been revised to clarify that, although the taxpayer is generally barred from invoking the provisions of section 482, the taxpayer may

report an arm's length result on its original tax return, even if such result reflects prices that are different from the prices originally set forth in the taxpayer's books and records. . . . Section 482 is concerned only with whether the taxpayer reports its true taxable income, and whether or not this result is consistent with the taxpayer's books, or is corrected in the books, is generally irrelevant to this inquiry.⁸

Neither the regulation nor the preamble says anything about the consequences of reporting on a basis different from the basis on which the transactions in question were actually priced and booked. There is no reference, in particular, to any obligation to adjust or attempt to adjust pricing in the other country—or, for that matter, even to informing the other country that such reporting has occurred.

The regulation says that the taxpayer “may” report on the basis of prices other than those actually charged, but the permissive wording is somewhat misleading. Code sections 6662(e) and (h) and the regulations issued thereunder impose substantial penalties in the event of transfer-pricing adjustments in excess of certain amounts, and these penalties may be avoided only by mustering certain limited types of defence.⁹ A taxpayer that knew or had reason to know at the time its return was filed that the prices actually charged would not meet the arm's-length standard would be hard pressed to defend itself effectively. Such a taxpayer would be well advised to report in accordance with its understanding of the proper arm's-length price even if that price differed from the price actually charged.

The transfer-pricing methods envisioned by the section 482 regulations are in many situations retrospective¹⁰—that is, they depend upon prices or profits found in transactions comparable to those of the taxpayer, and these comparable prices and profits generally were not knowable at the time the taxpayer's transactions were priced or booked or, indeed, before the close of the taxpayer's taxable year.¹¹ If the taxpayer comes to realize that the prices actually charged will not meet the standard established by the regulations, and that the result will be too little US income and therefore too little US tax, section 1.482-1(a)(3) permits the taxpayer to protect itself from penalties by filing in accordance with what it believes the regulations require.¹² In this case we do not speak of arbitrage, of course. To the contrary, the taxpayer creates by its filing a potential double tax situation, since the items that it sold to its foreign affiliate for 15 are now reported in the United States as sold for 20, even though the affiliate entered them in its cost of goods sold at 15 and reported income in its country of residence accordingly. The difference of 5 between the invoice price and the price used on the US return will thus be taxed twice, by the United States and by the other country as well, unless an attempt is made to rectify the situation. If there is a treaty available, it should be invoked.¹³ This is the obverse of arbitrage—not double non-taxation but double taxation in the classical sense of that term (nearly).

Suppose, however, the methods envisioned by the transfer-pricing regulations yield an arm's-length price not of 20 but of 10.¹⁴ Since the penalty provisions of section 6662 do not apply to an overpayment of US tax, the “may” in

section 1.482-1(a)(3) seems truly permissive in this situation. But what taxpayer would choose, except in the rarest of circumstances, to overpay its tax? The taxpayer may not be required by law to report a price lower than the one actually charged, but if the arm's-length standard allows and even, one may say, invites it to do so, it should be expected to do just that.¹⁵

Here is where the going gets tough. The theory of section 482 and the regulations that interpret it is that arm's length is the right answer. It is not the right answer only when the answer favours the United States. At least we have not thus articulated the standard and, given the skepticism voiced by much of the world with respect to the regulations as they stand, it seems unlikely that we would do so. A one-way rule might give rise to difficulties with the US definition of "arm's length" in circumstances where the United States seeks to apply the standard to its benefit. Such a tainted standard could be difficult to defend in international tax circles and could become expensive in terms of foreign taxes, and foreign tax credits, that the United States is forced to accept. Nor is the two-way rule simply an expedient choice. US authorities have come to believe that "arm's length" can be reinterpreted into workable standards, and that those standards yield practically as well as theoretically correct results. As the preamble to the final regulation says, the focus of section 482 is on "true taxable income," and it is generally irrelevant whether this result matches the taxpayer's books. It therefore seems highly unlikely, and possibly even undesirable, that the rule of section 1.482-1(a)(3) would or should operate in one direction only. If the "best" transfer-pricing method yields 10 when the actual price charged was 15, the taxpayer "may" file a return using 10, and there does not appear to be any valid criticism—legal, ethical, moral—if it chooses to do so.¹⁶

From the viewpoint of the foreign affiliate, and its country of residence, the situation is different. That country has its own laws. It may not wish simply to adopt those of the United States, to "see the light" emanating from the section 482 regulations, and to undertake to end the arbitrage by accepting the US position. Let us assume that, as is common, that country's tax laws depend upon local accounting rules; that those rules, in turn, depend purely and simply upon invoice prices, at least in the absence of deliberate malfeasance; and that the other country has a consistent practice of treating the prices "actually charged" as binding—in fact, that it will not permit a taxpayer to diverge from those prices on its own initiative and takes the position that invoice prices can be altered only if the country's tax administration initiates a transfer-pricing adjustment. Let us postulate, finally, that under its view of transfer pricing, the other country sees nothing wrong with a price of 15 for the transaction here in question.

By reason of the combination of US transfer-pricing methods and section 1.482-1(a)(3) on the one hand and the other country's own rules respecting invoice prices on the other, 5 of value thus escapes taxation in either the United States or the other country. It is true that if 15 was paid by the foreign affiliate, the 5 of non-taxed value will be viewed by the United States as either a dividend

or a contribution to capital, depending on the structural relationship between the US company and the foreign affiliate.¹⁷ Revenue Procedure 99-32 establishes a procedure whereby cash may be repatriated in this situation to avoid these collateral consequences.¹⁸ However, the consequences in question are US tax consequences only. Revenue Procedure 99-32 is silent in regard to consequences in the other country (except insofar as the US tax books are concerned), and does not require the taxpayer or the affiliate to bring the situation to that country's attention. It should be noted that the taxpayer in many cases would have no interest in the voluntary procedure established by Revenue Procedure 99-32, since a dividend may carry foreign tax credits with it whereby any US tax is eliminated and a contribution to capital is not subject to US tax at all.

The mismatch in pricing is not happenstance, not a result incapable of being planned for. Taxpayers resident in the other country are presumably aware of the position of the local tax authorities with respect to prices the taxpayers set. Doubtless they know the meaning of evasion under local rules, and can plan to stay clear of it. Still, they may set prices with their US affiliate in the hope, possibly even in the expectation, that application of the comparable profits method or whatever else the section 482 regulations call for will produce a different and better result in the United States. In other words, the difference in attitude and law toward transfer pricing, hazy at the edges, may be clear enough to invite creativity by knowledgeable taxpayers. And, of course, the world has plenty of those.

Now we have a full-fledged arbitrage situation. The foreign buyer takes care to remain within the bounds of legitimate pricing as established under local standards. The US seller, on the other hand, charges a team of economists with determining whether the invoice price falls above the arm's-length standard. If it does, section 1.482-1(a)(3) is invoked and a lower price is used to compute taxable income on the US return.

These are what I believe to be the relevant questions: Should the United States have a problem with that? If so, what is it going to do about the problem?

Some US tax policy makers operate on the assumption that income should be taxed *somewhere*. The best justification for such an assumption, I believe, is that the opportunity to achieve untaxed income represents a magnet for investment that would not otherwise be made, or not otherwise be made in the same way, resulting potentially in both inequities among US taxpayers and depletion of the US tax base. This probably explains why the United States has experimented in many ways, and over many years, with using foreign tax systems to determine whether US investment is carried on legitimately outside the United States through foreign corporations.¹⁹ This also explains our ambivalence toward the goal of reducing foreign tax²⁰ when it would appear that the United States saves money (through a reduced foreign tax credit) when foreign tax is lowered and, in any event, lower foreign tax on US persons arguably translates, albeit only to some extent and indirectly, into economic benefits for the United States. The

problem is that if these benefits—which, of course, accrue most directly to those persons or entities directly involved in the pertinent transactions—are available only upon foreign incorporation, there will be more, probably a lot more, foreign incorporation. This, in turn, could threaten the US tax base, or at least there is a rational basis for believing that it could threaten the US tax base.

So, yes, we might have a problem with the above-described arbitrage example because its benefits could induce some persons who would not otherwise establish foreign affiliates to do so and sell items to those affiliates that would otherwise be sold, and the income from such sales fully taxed, in the United States. The argument may not be entirely compelling, however. The example involves a sale from the United States to a foreign affiliate, which then resells the purchased item and realizes income from such sale. Presumably the other country imposes a decent rate of tax on the income of the affiliate, since the point of the arbitrage is to escape taxation that would otherwise apply. Tax havens and other low-tax situations should not be considered here, because such jurisdictions raise problems without regard to arbitrage, even if transfer prices in the United States and the other country are identical. If we assume, therefore, that the other country imposes a “real” tax on the foreign affiliate, the question is whether the arbitrage opportunity described above is significant enough to lead persons to behave in ways they otherwise would not. The answer to that question is far from obvious. It may depend in large part on whether the interstices between the requirements of US transfer-pricing rules and their analogues in other countries are broad enough to justify planning activity. That inquiry is doubtless unsettled, as the pertinent rules throughout the world may be both vague and variable over time and across different industries.

So let us pass the question, even though we have not answered it, and let us assume that there is a compelling reason—relating to the situs of investment, threat of competition with US persons, taxpayer inequities, or something else—that would undergird the conclusion that the United States does have a problem with arbitrage of the sort identified above. What might the United States do about it?

The choices, it seems, are limited. The transaction, by hypothesis, falls within the tolerances established by the laws of both countries. Moreover, the laws in question in the United States have been recently and thoroughly reviewed: it was determined for sound reasons of tax administration and transfer-pricing policy that taxpayers should be allowed, at their initiative, to report income on a basis different from invoice prices. In light of the arbitrage potential, should the rules be changed? When some US professionals discuss these issues, an unstated assumption seems to be that the other country, given time, will perceive the wisdom of the US rules and put an end to the arbitrage. That, however, is not realistic. The United States cannot determine—may not even be able to influence—the course of the other country’s laws. There are many differences of philosophy, cultural tradition, and tax administration that prevent any one country from fully

understanding the workings of another country's tax system. If arbitrage is to end here, the United States is probably going to have to undertake the task itself.

Certainly it is conceivable that US law could be amended to take aim at the offending transaction. As noted above, altering section 1.482-1(a)(3) so that it operates only when US tax liability is *increased* by reporting on a basis different from invoice prices seems profoundly inconsistent with US efforts to interpret the arm's-length standard. But are there alternatives?

The United States might prevent taxpayers from invoking section 1.482-1(a)(3) in any case in which a price other than the "arm's-length" price is reported for tax purposes in another taxing jurisdiction. Again, assuming that the arm's-length standard should be applied in neutral fashion to cases where invoice prices are either lowered or raised, the suggested rule should be applied both when the arm's-length price is 10 and when it is 20 (the invoice price being 15). The approach would, however, raise issues under the penalty regime of section 6662, since the taxpayer whose foreign affiliate reports the transaction at 15 would be precluded from reporting the arm's-length price of 20 in the United States. The penalty provisions could be amended to condone non-arm's-length reporting in circumstances where the arbitrage rule precludes the arm's-length choice, but is that really where US policy wants to go? Abhorrence of arbitrage would then trump the encouragement of arm's-length pricing that lies at the heart of the transfer-pricing regulations, although the Internal Revenue Service might still be allowed to adjust the price to 20 or 10, at its discretion. Mountains of disclosure could be required so that the IRS would know of its options. Presumably, in most cases, it would choose to adjust the price to 20 if that was the arm's-length result but leave the price at 15 if the arm's-length result was 10.

There are some practical problems with the proposed rule. As noted previously, a major emphasis of the section 482 transfer-pricing rules has been reduction of the burden on tax administration. This explains both the emphasis on using taxpayers' own documentation, prepared in advance, to review transfer prices, and the enhanced penalty regime of section 6662. It also explains Treasury regulation section 1.482-1(a)(3), which the proposed arbitrage rule would, to some extent, undercut. Moreover, the proposed arbitrage rule would not be easy to enforce. Other countries may not have tax filings at the same time as the United States. And when such filings were available, the IRS would have to stand ready to review them. A measure of self-enforcement could be expected, and perhaps with an adequate penalty for non-compliance the practical difficulties could be tolerated, but the rule would surely represent a step backward in terms of both substantive and procedural aspects of section 482.

In addition, there lies a conceptual problem in the deference that the suggested rule gives to other countries' tax provisions. The example involves a hypothetical foreign rule that is simple—acceptance of the invoice price. Suppose, however, the other country either has or adopts a less direct, perhaps formulary, method of determining the transfer price for transactions between

affiliates. Is the United States prepared to prevent taxpayers from reporting on what it agrees is an arm's-length basis simply because the country on the other side of the transaction has (what we see as) an idiosyncratic view of pricing? The result seems inconsistent with the main thrust of the section 482 regulations and the considerable effort of US policy makers to reach "true taxable income."

The leading alternative to the approach just suggested is to do nothing. Allow Treasury regulation section 1.482-1(a)(3) to operate as intended. Accept the fact that, in some cases, income will escape taxation in any country. Insist on whatever collateral consequences flow from reporting on a basis other than the invoice, so that excess value moving in either direction is accounted for in the US tax universe. And, perhaps most telling for the general subject of arbitrage, concentrate upon that universe as a self-contained entity, with rules designed to protect and replenish the US fisc but *not* necessarily to ensure that other countries receive their fair share of tax. In other words, leave taxation of other countries to the other countries, and stick to US tax policy concerns. Oddly, this sounds nearly heretical as a statement of US tax policy in the year 2000.

At the end of the day, the appropriate response to "transfer-pricing arbitrage" is quite unclear. One can conceive of reasons why arbitrage *might* be problematic, but none emerges in sharp focus. At the same time, reasons stemming from a visceral reaction to arbitrage are suspect: it does not appear appropriate for US tax policy makers to insist that another country adopt any particular approach to transfer pricing. And even if it were, there are limits to the ability of the United States to influence the choices of other countries. Nor is it clear *why* all income must be taxed somewhere—or, more specifically, why the ability of taxpayers to escape taxation on a slice of income is detrimental to the interests of the United States.

There are, however, tangible US interests at stake in any effort to adopt special rules with a view to eradicating arbitrage. As the above discussion suggests, the United States has adopted its transfer-pricing rules, including Treasury regulation section 1.482-1(a)(3), for good and explainable reasons. Although it is not impossible to rationalize exceptions to those rules in the name of combating arbitrage, the need for any such exceptions must be weighed against the harm that the exceptions may inflict upon other policy interests, including the transfer-pricing regime itself.

Notes

- 1 Quoted in Bureau of National Affairs, *Daily Tax Report*, March 17, 2000, at G10-11.
- 2 H. David Rosenbloom, "International Tax Arbitrage and the 'International Tax System'" (2000), vol. 53, no. 2 *Tax Law Review* 137-66.
- 3 The David R. Tillinghast Lecture, delivered at NYU School of Law on October 1, 1998.
- 4 The article does identify aspects of subpart F and other US statutory provisions that may be implicated by arbitrage because they rely upon the assumed operation of other nations' laws,

and arbitrage puts the assumptions, which are not necessarily correct in any event, in doubt pretty much at the will of the taxpayer. The article suggests that the practice of looking to rules of other countries to advance US policy objectives may be injudicious.

- 5 These emerged as TD (Treasury Decision) 8552, 1994-2 CB 93, final regulations relating to transfer pricing under section 482 of the Internal Revenue Code of 1986, as amended (herein referred to as “the Code”). Unless otherwise stated, statutory references in this article are to the Code and the regulations thereunder.
- 6 The recent decision in *United Parcel Service of America, Inc. v. Commissioner*, 78 TCM 262 (1999), concerned a transaction that took place in 1983.
- 7 Treas. reg. section 1.482-1(a)(3).
- 8 *Supra* note 5, at 98-99.
- 9 Treas. reg. section 1.6662-6.
- 10 This is certainly the case with the various approaches subsumed under the heading of the “comparable profits method.” See Treas. reg. section 1.482-5. CPM is probably the most common approach used today in applying the arm’s-length method in the United States.
- 11 In many cases the information may not be known at the time the taxpayer’s return is filed, but the nearly nine months’ delay between year-end and filing (on extension) of a corporate return in the United States represents a pretty good opportunity to become informed.
- 12 Treas. reg. section 1.6662-6(a)(2) states, “Whether an underpayment is attributable to a substantial or gross valuation misstatement must be determined from the results of controlled transactions that are reported on an income tax return, regardless of whether the amount reported differs from the transaction price initially reflected in the taxpayer’s books and records.”
- 13 The invocation should be treated as a US-initiated adjustment for purposes of the mutual agreement procedure, since the combination of Code sections 6662(e) and (h) and Treas. reg. section 1.482-1(a)(3) effectively requires the US taxpayer to report on a basis other than the price “actually charged” and presumably accepted for tax purposes in the other country.
- 14 The example ignores, for illustrative purposes, the fact that the regulations contemplate a range, not a single transfer price. The factual pattern examined in the text can be complicated when the actual price charged falls within an arm’s-length range that would permit a more advantageous (in this case, lower) price or when the actual price falls outside the arm’s-length range and the taxpayer must decide where within the range to report (choosing, for example, between the median price suggested by the comparables and the demarcation of the lowest quartile). These matters, quite common, give rise to further issues, but ones extending beyond the focus of this paper.
- 15 There are, however, collateral consequences to reporting on a basis that differs from the price actually charged, and these will ensue both when the reported price is lower and when it is higher than the invoice price. If there has been a payment of 15, reporting an arm’s-length price of 10 means that 5 of “excess value” has come into the United States and must be accounted for. If the foreign affiliate is a parent of the US company, the likely characterization of the 5 is a contribution to the capital of the US subsidiary. If the foreign company is the subsidiary and the US company its parent, there has been a distribution and, if the foreign company has sufficient earnings and profits, a dividend. If the foreign affiliate is a sister corporation, the 5 may be viewed as a distribution to the common owner of both corporations, although this is not entirely clear. See *Central de Gas de Chihuahua, SA v. Commissioner*, 102 TC 515 (1994), and the Tax Court’s utterly unsatisfactory attempt to distinguish Rev. rul. 78-83, 1978-1 CB 79. Of course, if payment has not been made, there may be other ways of regarding the 5, such as adjusting an open account.
- 16 Code section 1059A, with its linkage to customs valuations, could play a role in the case of inbound sales, but not in the outbound sale used in the example in the text. Moreover, even in

the case of inbound sales, the application of section 1059A is hardly inevitable—many situations involve no customs duty at all.

17 See *supra* note 15.

18 1999-34 IRB 296.

19 See *supra* note 4.

20 See Notice 98-11, 1998-1 CB 433, a highly controversial interpretation of subpart F aimed in large part at taxpayers using “hybrid branches” to reduce foreign tax expense without triggering any of the provisions of subpart F.