Milking versus Parking: Transfer Pricing and CFC Rules under the Internal Revenue Code

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I have drafted this comment in connection with the international taxation panel of the NYU-UCLA symposium celebrating the 100th anniversary of the Internal Revenue Code. This occasion could have been taken as an invitation to write about just about anything, past, present or future related to international taxation under the Code. But I thought it an apt time to attempt to write something with an evolutionary or historical perspective, even though that is not my normal mode of scholarship. One of the interesting things about observing the evolution of a statute with hindsight -- particularly one as complex as the Code -- is the ability it gives one to think, and rethink, the way in which different parts of the statute evolve and intersect with one another over time. Frequently, distinct statutory provisions are enacted which are "conceptually proximate" to one another. That is, the provisions deal with ostensibly distinct problems, but problems that are, nonetheless, related to one another in some way. This creates two interesting possibilities over time. First, one provision may be used to combat the core problem that is the focus of the other doctrinal provision, to the *exclusion* of the latter provision. This is a case of killing two birds with one stone. The rationale is statutory parsimony. If one set of rules can cure two problems (the core problem it was designed for as well as a closely related one), that sounds better than using two sets of rules. Second, one provision may be used to combat the core problem that is the focus of the other doctrinal area, in *conjunction* with the latter provision. This is the case of killing one bird with two stones. The rationale is statutory redundancy. If we are not certain that a given provision can solve the core problem it is meant to solve, then piling on additional remedies from the related area may seem a good idea.

Parsimony and redundancy, cast in this way, sound like statutory virtues. But they can also be statutory vices. Sometimes parsimonious solutions are sufficiently ill-suited to the problem at hand that the benefit of savings does not exceed the cost of a second best solution. Sometimes redundant solutions can make one complacent, relying too heavily on second best backstops to first best rules.

What I would like to do in these comments is explore this dynamic with respect to a particular pair of bedfellows in the international provisions of the Code, namely the international transfer pricing rules and the controlled foreign corporation rules. It is often observed that the CFC rules function as a backstop to the transfer pricing rules. This is an instance of redundancy. It is also not difficult to locate instances in which the provisions work together in a way manifesting an attempt at parsimony.[1] But are these good instances of redundancy and parsimony? And how exactly can we go about figuring out the answer to this? My premise here is that the preferred way to go about this is to return to basics and be explicit about the *core* functions of the provisions.

I will develop this in more detail below but the basic idea is fairly simple and, I think, not at all controversial or new. At its core international transfer pricing is about equalizing the case of a US entity transacting with a related foreign entity and the case of a US entity transacting with an unrelated foreign entity.[2] The core concern is price manipulation or profit shifting in the related case, or what I will call here "milking." Crucially, the transfer pricing analysis is undertaken against an assumed baseline regarding divisions of the international tax base. The transfer pricing rules (at least in the non-treaty context) are not themselves *constitutive* of that division. By contrast, at the core, CFC rules should be understood to be about the degree to which the case of a US entity and a

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1. See *infra* ___.
2. I focus on the international case here only. Analogous issues can, and do, arise in the wholly domestic case.

related foreign entity should be put on a par with the case of a US entity conducting business abroad through a foreign branch. The core concern here is the way in which the US entity can contract the tax base by earning profit through foreign entities and deferring tax by retaining the profits abroad. We could refer to this basic issue as one of "parking." Crucially, the CFC rules (at least as they have taken form in the U.S.) are constitutive of the international tax base division issue.

While one can use parking rules to defeat milking abuses, and vice versa, the way this has come to pass -- and to have been accepted -- is largely an artifact of the way in the the CFC and transfer pricing rules have evolved over time, and continue to evolve, along parallel tracks. I divide the discussion below into two parts. First, I review some of the key points regarding history and the way in which the CFC and transfer pricing rules came to be understood as relating to one another. This will set the stage for describing in more detail what I take to be the core functions of CFC and transfer pricing rules -- the distinction, that is, between milking and parking. Second, I use this framework to analyze a sampling of issues under the CFC and transfer pricing rules, in an attempt to shed some light on questions about parsimony and redundancy. I will look at two old issues (the commensurate with income standard and the contours of foreign base company sales income) and two new issues (the proposals for profits-based elements under subpart F and proposals for expanded intangibles definitions under section 482). These are just illustrative. The basic idea is to show how sharper thinking about core functions should affect analysis of how we should choose which statutory instrument to counter which problem.

I. History and Core Functions

I do not undertake here a comprehensive historical tracing of the CFC and transfer pricing rules as this exercise has already been done elsewhere.[3] Rather, I focus on the crucial enactments which are sufficient to make out my basic claim about the interrelation between the two bodies of doctrine. Note first that the transfer pricing problem has been around nearly as long as the Code itself. The earliest response to the transfer pricing problem came by regulation in 1917. Thus according to regulations under the War Revenue Act of 1917 the Commissioner of Internal Revenue was given the power to force affiliated corporations to make a consolidated return to "equitably determine" taxable income.[4] For these purposes this might include consolidation of the accounts of a foreign corporation and a domestic corporation, thus providing an initial example of the Commissioner being empowered to restate profits originally reported as belonging to a foreign entity as instead belonging to a domestic entity. Four years later this concept of forced consolidation was elevated to a statutory principle, under section 240(d) of the Revenue Act of 1921. Even at this early date the House Report for this legislation characterized the basic problem as one in which foreign subsidiaries were "milking" the profits of domestic parent companies.[5] Seven years later section 45 of the Internal Revenue Code was enacted, replacing the forced consolidation regime. This section is the direct statutory predecessor to modern section 482 and used for the first time the "clear reflection of income" and "prevention of evasion of taxes" language that still survives in the modern statute. In 1934 regulations under section 45 introduced the arm's length standard for the first time. Of crucial relevance to the historical picture here, though, it was more than three decades before the arm's length standard achieved any sort of firm grounding comparable to that enjoyed by

3. For historical background on CFC legislation, see Treasury Dep't., *The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, 1-22 and Appendix A (2000) [hereafter "Treasury subpart F study"]. For historical background on the transfer pricing rules, see Stanley Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 635 (1986).
4. [Cite Regulations.]

the standard in its current incarnation. Specifically, courts did not firmly embrace the standard as a mandatory principle under section 45 (or section 482, which replaced section 45 in 1954) until 1966.[6] Further, there was no detailed regulatory guidance on the implementation of the principle until 1968.[7] Thus from 1934 until the late 1960's the transfer pricing regime was nominally subject to a mandatory arm's length principle with governmental authority to make adjustment to clearly reflect income and prevent the evasion of taxes. The reality of the matter, though, is that during these years the approach to transfer pricing was in fact hardly defined at all, as courts took on considerable discretion and range of response to fill a regulatory vacuum.

It is extremely important to pay heed to the fact that it is during this period of essentially zero guidance on the operative transfer pricing norm that the CFC rules were first enacted. There is no question that the enactment of the CFC rules was viewed as counteracting what was perceived to be an ineffective regime under section 482, providing an indication that the CFC rules have always been understood to function as a backstop to the transfer pricing rules.[8] But to fill out the historical significance of this backstop role, it is necessary to consider the way in which the CFC rules evolved from initial proposal to actual enactment.

Consider two items of relevance here. First, shortly after taking office in 1961 President Kennedy issued a message to Congress in which he described the basic tax avoidance problem with foreign corporations as involving: "artificial arrangements between parent and subsidiary regarding intercompany pricing, the transfer of patent licensing rights, the shifting of management fees, and

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5. [Cite Legislative History to 1921 Act.]
6. *Oil Base, Inc. v. Commissioner*, 362 F.2d 212, 214 (9th Cir. 1966); *Eli Lilly & Company v. Commissioner*, 372 F.2d 990 (1967).
7. *See* T.D. 6952 (Apr. 15, 1968).
8. Hearings on the President's 1961 Tax Recommendations Before the Committee on Ways and Means, 87th Cong., 1st Sess., vol. 4 at 3549 (1961) (statement of Commissioner Caplin); see Stanley I. Langbein, *supra* note 3, at 643-44.

similar practices which maximize the accumulation of profits in the tax tax haven."[9] What is interesting about this statement is the way in which it groups together two discrete phenomena under the single rubric of "artificial arrangements." Thus questions about intercompany pricing and shifting of management fees are really about benefits that can be captured by related parties relative to unrelated ones. This is the basic "milking" problem described in the introduction. The reference to the transfer of patent licensing rights is different. The problem here could involve abusive pricing but it would not have to. The more immediate issue there was the deferral that a company could achieve if it could make a tax-free outbound transfer of intangible property. The baseline here is not the unrelated party but the unincorporated foreign branch, which would not benefit from any deferral. This is the basic problem of "parking."

Second, consider that as initially proposed by the House Ways and Means Committee in 1962, the CFC rules would have led to current inclusion of *all* income earned through controlled foreign subsidiaries.[10] This substantive result of full inclusion and the collapsing of pricing and entity formation in the above statement are of a piece with one another. Clearly, if the norm for base definition is to include everything, then pricing issues disappear completely, as any advantage from profit shifting in the first instance would be immediately reversed through the full current inclusion result. In such a world, CFC rules would operate not so much as a backstop to rules regarding pricing issues as much as a bludgeon that flattens the entire transfer pricing problem out of existence.

In reality, of course, the CFC rules as enacted look nothing like the universal inclusion rule initially proposed. In a story that has been told many times before the CFC rules attempted to strike

9. [Cite.]

10. *See* Treasury Subpart F Study, *supra* note 3, at ___.

some balance between concerns about excessive deferral and concerns about competitiveness, resulting in the basic compromise position of deferral for essentially active income and current inclusion for essentially passive income.

This evolution from conception to enactment has important implications for how one should understand the role of the CFC provisions as backstop. As we just saw, under full inclusion the CFC rules, as bludgeon, are perfect backstop. By contrast, with partial inclusion we open up a serious divide between the two regimes. Of course the CFC rules *can* still function as backstop. Where they entail current inclusion profit shifting through artificial pricing will be of no avail. But as implemented we have a fairly weak connection between when the CFC rules will apply and the case where there is an actual pricing abuse. This is because the essential criterion under the enacted CFC rules regarding the active-passive line will correlate quite inexactly with pricing abuses. Admittedly, the overlap is not zero because passive activities will often be good candidates for pricing abuses. But still this is highly inexact. Further, not only is the CFC regime as enacted an imperfect backstop, it must also be remembered that as compromise legislation it is subject to ongoing dynamic pressures about what goes on which side of the line. This is the basic constitutive question of base definition under the existing CFC rules. This means the CFC rules have an ongoing normative benchmark to satisfy, which is *not* about abusive pricing.

To be clear, the two regimes remain closely related and can be used to bolster one another. Strengthening CFC rules *can* counteract pricing abuses on the margin. Transfer pricing rules can be used to reverse deferrals that would otherwise be permitted under overly generous CFC rules. Thus statutory redundancy and parsimony remain important possibilities. But these truisms do not answer the hard questions about when the regimes *should* be used in such a fashion. To answer those questions one should begin with an understanding of how we should view the core functions of the regimes and also how we should understand the origin of the deficiencies we are seeking to remedy.

In developing a description of the core notions of the transfer pricing versus CFC categories it is helpful to distinguish along a range of different variables. I focus on three here, which seem to be of greatest relevance. Specifically, I consider the problem addressed, including the relationship of the regime to the substantive definition of the tax base; the relevant reference transaction or taxpayer; and the nature of the remedy employed. As one considers these categories a few points should be kept in mind. First, the project here is to describe an idealized form of such regimes, while shedding light on actual U.S. practice. The exercise is not meant, however, to provide a description of current forms of such regimes under section 482 or subpart F. To be sure there will be substantial overlap between the idealized forms and the enacted regimes, but the whole point of the exercise is to understand better how departures from the ideal could inform one's understanding of the line between good and bad redundancy and parsimony. Second, in considering an idealized form of transfer pricing I am restricting attention to arm's length transfer pricing with separate entity accounting. The analysis would look different -- especially regarding baseline and reference point issues if the focus were instead on formulary apportionment. Third, the analysis proceeds under an assumption of a baseline of a worldwide tax system. This is in keeping with my goal to keep matters general but with a grounding in specific aspects of the U.S. system, which will assist the ultimate prescriptive analysis.

We can begin with the basic problem confronted by each of the idealized regimes. CFC regimes confront the problem that under a worldwide tax system (for domestic entities but not, obviously, foreign ones) taxpayers can reduce tax burden by earning income through foreign subsidiaries. The advantage can be enjoyed indefinitely absent repatriation -- thus the basic "parking" terminology. In solving this problem, enacted CFC rules must make some decision about what will count as permissible deferral versus what not. The factors that will go into that calculus are familiar. If one pushes too much away from deferral this may harm competitiveness (and put pressure on avoiding U.S. incorporation in the first instance). If one pushes too far in the other direction, then the country may sacrifice portions of the tax base without offsetting benefits. In evaluating these functions, CFC rules thus effectively define the scope of the base. This is the sense in which I consider the idealized form of a CFC regime to be constitutive of the base. This points to the key substantive difference between the idealized regimes. Once one has set substantive base rules there will naturally be incentives for taxpayers to characterize income as arising on the tax preferred side of the line. Intercompany price manipulation is one chief way in which taxpayers may attempt this. This gives rise to the basic "milking" characterization. This simple picture hopefully shows how the two idealized regimes are intimately connected -- but also conceptually distinct. Manipulative pricing can undermine base determination issues established by CFC rules (for example, by overcompensating factors that enjoy deferral relative to those that don't). And, as we have seen, expansion of the base under the CFC rules can counteract abusive pricing.

In spite of these points, I suggest that we should still see the regimes as conceptually distinct. Note first that in spite of these important overlaps there are obvious cases where there is no overlap. This happens in each direction. Thus there are cases that will fall into the core of transfer pricing where the core CFC regime will have nothing at all to say about the matter. This will be the case, for example, where a U.S. company attempts to strip out part of the U.S. base by making artificially high payments to a foreign parent company. Running in the other direction there will be many cases in which the CFC regime would mandate current inclusion under constitutive base definitions even in the complete absence of any artificiality regarding pricing arrangements. Moreover, the fact of non-perfect overlap is an essential rather than contingent feature of these regimes. This follows form the constitutive versus non-constitutive distinction drawn above. The core of the CFC regime, because it involves base definition, is an exercise that must be ex ante and of general application. The core of the transfer pricing regime, by contrast, is an ex post exercise which is taxpayer specific.

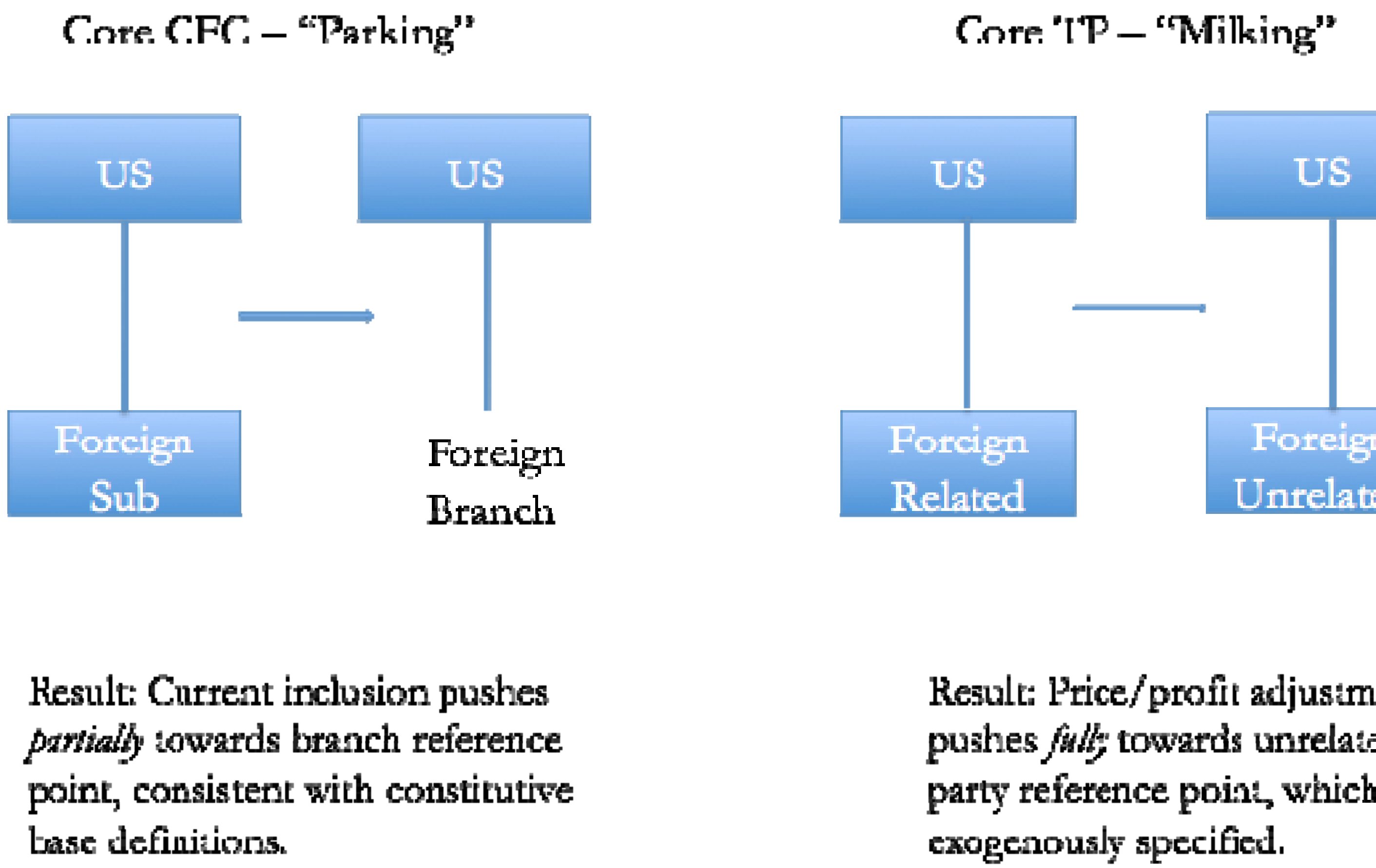
Turning to the question of reference point, the analysis here follows the basic identification of the fundamental problem above. As CFC rules at the core deal with the question of the amount of permissible deferral, the relevant reference organizational form is that of a US company operating abroad in branch form. By contrast, under arm's length transfer pricing the relevant baseline, of course, is that of unmanipulated prices, which would arise as between unrelated parties.

Finally, regarding remedy, core CFC regimes should be associated with some type of current inclusion or alternatively a finance charge that effectively removes the deferral benefit. Core transfer pricing rules, by contrast, will operate by price or profit adjustment across entities.

There is a thread that links these three elements of problem, reference point, and remedy. In other words, the stated remedy is well tailored, in light of the problem and reference point for each case. Thus current inclusions under a CFC regime establish the base as defined by the constitutive norm and move the foreign subsidiary case closer to the tax treatment of the branch case. Analogously, price or profit adjustments under an arm's length transfer pricing regime will move the tax result in alignment with the exogenously specified base results for unrelated parties.

Conversely, one can see that remedies in one core regime can be used to address the problem in the other core regime but only imperfectly. Thus one will tend to move in the correct direction in such a case but with no exactitude regarding magnitude. For example, one can use price adjustments to end a deferral benefit, but such adjustments will have the twin failing of being taxpayer specific rather than general and of being keyed to the unrelated party pricing benchmark, which bears no conceptual connection to the ideal substantive base determinations under the core CFC regime (linked to the competitiveness-base erosion balance). And, if one uses the core CFC remedy of full inclusion to address pricing irregularities this will go in the right direction but will likely overshoot the mark as the inclusion amount will not be keyed to the actual artificial amount of profit, thus putting the related party structure potentially in a different position from the unrelated party structure.

The above distinctions can be summarized in the stylized diagram below.



As a preview to what is to come, one of the basic points I would like to emphasize is the way in which paying inadequate attention to the core aspects of these two issues can invite (unnecessarily) these sorts of disconnects between remedy and underlying problem.

II. Applications

A. The Commensurate with Income Standard.

The commensurate with income standard (CWI) is a particularly good candidate to analyze under the framework I have developed above because the identical statutory language (i.e., "commensurate with income") is used in distinct statutory provisions that are arguably (though this case will have to be made) about parking and milking, in turn. Specifically, one encounters the CWI standard under section 367(d) regarding the treatment of outbound transfers of intangibles in what would otherwise be a non-recognition event under the corporate reorganization provisions. Here the taxpayer will be treated as having sold the intangible and must include in income an amount that is "commensurate with the income" attributable to the intangible. And, one also encounters the identical language under the second sentence of section 482, which tells us that income from the transfer or license of intangibles shall be "commensurate with the income" attributable to the intangible. Of further interest is the fact that these two provisions each entered the Code as part of the same legislation, that is in the Tax Reform Act of 1986. I consider each of these provisions below, in turn.

1. <u>Section 367(d)</u>. It seems fairly clear that the core problem that this section is meant to deal with is about parking rather than milking. The concern, which goes all the way back to the initial enactment of the subpart F rules, is that taxpayers would be able to transfer low basis/high value intangible property out of the United States and hold such property in foreign corporate

subsidiaries. Of course, this would be no issue at all *if* one had either a full inclusion regime (as originally proposed under subpart F) or even a partial inclusion regime, which happened to pick up the royalty income for current inclusion under the CFC rules. In the event of such inclusions, one would simply replicate the current inclusions that follow in the wholly domestic case, where the decision has already been made under the Code to grant whatever deferral is possible through the non-recognition and substituted basis rules of subchapter C. In reality, the need for section 367(d) shows that taxpayers are able to navigate the CFC rules on transfers of such outbound intellectual property, for example, by planning into the active royalty exception under subpart F.[11] One could attack such a problem by modifying the substantive CFC rules, generating further current inclusions under the CFC constructive dividend mechanism. Or, one could take the basic approach under section 367(d) which is essentially to force actual payments between the foreign subsidiary and the U.S. shareholder/transferor of the intangibles.

So far, this is all about parking and involves neither parsimony nor redundancy. It looks like a case of using the core solution to the core problem. But in fact, this is *not* how matters have evolved as a regulatory matter. There are two relevant pieces of information here. First, under the section 367(d) regulations the commensurate with income standard has been interpreted as requiring the application of the standards developed under section 482 regarding intercompany pricing.[12] Second, if one then turns to the relevant application of the standard under section 482 we see that the problem has come to be analyzed as a milking problem with a milking remedy. (For the reasons discussed below this is not the only possible description of the problem or the remedy but it does describe the current state of interpretation of the provisions under section 482). Thus in national

11. *See* section 954(c)(2)(A).
12. Treas. reg. section 1.367(d)-1T(c).

guidance the IRS has clarified that the CWI standard under section 482 is to be applied based upon *anticipated* performance at the time of the transfer of the intangible, with actual future performance serving an evidentiary function regarding the acceptability of the taxpayer's pricing.[13] The alternative possibility would be to rely upon actual future performance to set the pricing. That latter approach starts to look more like a parking remedy -- that is actual current inclusion of amounts realized by the foreign subsidiary in the future.

In the framework I have set out this looks a lot like a case of parsimony. The statute uses identical language across the two provisions and then by regulation we have a collapsing of standards. This saves one the work of writing two sets of complicated regulations under the two statutory frameworks. But is this good parsimony? Here, I would argue that it is not, and we can see this by thinking about the core function and the associated remedies. Presumably, the actual result we are trying to generate, and the problem we are trying to solve, is the correct line to draw on the active/passive royalties dimension which generates some possibility for deferral in the first place. If we have drawn that line exactly correctly, it is difficult to see why we need a provision like section 367(d) in the first place. Its existence, then, should be understood as working in tandem with the active royalties provisions to curtail deferral opportunities. But from that perspective the remedy we are left with looks like an extremely poorly tailored one. Finding comparables at the time of transfer will be very difficult. The extremely amorphous way in which future actual experience affects the reasonableness of pricing determinations made in the past, with less information, under an arm's length test is meant to add clarity but this is highly questionable. In any event it must be asked what the highly imperfect results here have to do with addressing the underlying parking problem. A first best solution would be a parking solution, that looks to the underlying substance of the active

13. *See* AM 2007-07.

royalty exception. An alternate parking solution would be to divorce the interpretation of section 367 from the regulatory application under section 482, accepting that in light of the core problem at hand one *should* be looking at actual reported profits in future years and *not* the way in which future profits might have evidentiary influence on prior expectations. In sum it is difficult to see the case for good parsimony here.

2. Section 482. The analysis of CWI under section 482 is complicated by the fact that I think it is less clear what the core nature of the problem is. There are at least two possibilities.

One possibility is that the taxpayer transfers difficult to value intangibles with best possible information, available to both taxpayer and government, regarding the value of the intangible. The asset is a risky one, however, and demonstrates substantial variance in its returns. What problems does this present under arm's length transfer pricing? At first glance, we might say no problem at all because the results will be correct in the aggregate (or at least as "correct" as could be hoped for given informational limits). That is big winners may be offset by a lot of small losers, as, for example, under the basic pharmaceutical model. This might be an acceptable result from the government's perspective *if* we could be assured of symmetric treatment of gains and loses. But we can't assume that. In a regime of partial full inclusion the taxpayer is likely to retain some flexibility in accelerating losses while deferring gains. Note, however, that conceived in this way the problem is really more of a core parking problem (asymmetries in deferred gains versus currently included losses) than a core milking problem.

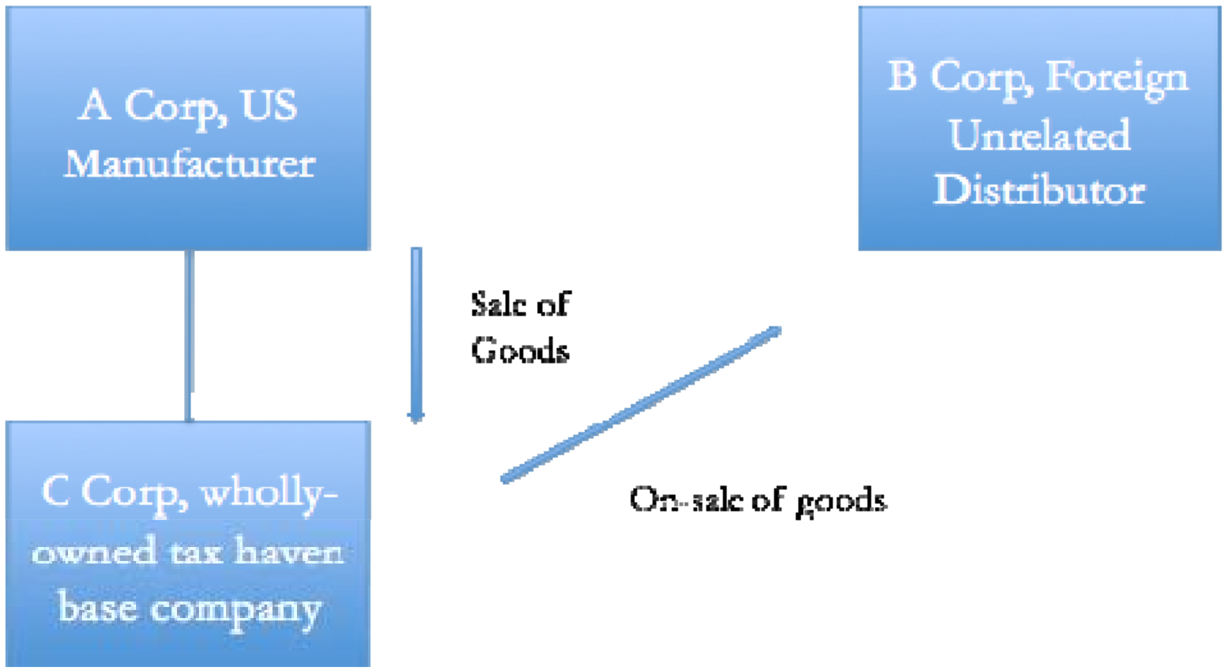
A second possibility is that the initial transfer is made with asymmetric information. That is, there is a thin base of comparables to examine and the taxpayer has better information about asset value than the government, with insurmountable proof problems. This looks more like a core milking problem. That is, it is a pricing abuse grounded in asymmetric information about asset value.

Under the administrative guidance mentioned above it seems clear that the interpretation of CWI under section 482 favors the latter interpretation. That is, by looking to prior expectations but with additional evidence from the future, the remedy is a pricing remedy. This is a case of neither parsimony nor redundancy but rather core remedy being matched with core problem. We, of course, may still be left with the other issue about asymmetry of losses and gains. The lesson of this discussion is that the current milking interpretation of CWI under section 482 as parsimonious solution to the parking problem (created by asymmetry of gains and losses) would likely not be a particularly strong response.

B. Foreign Base Company Sales Income.

We have just seen an instance of statutory interaction between the transfer pricing rules and the CFC rules which is suggestive of harmful parsimony. Not all interactions are similarly harmful, though. I consider here the case of the foreign base company sales income rules under subpart F. These are perhaps the paradigm rules that people have in mind when they describe the CFC rules as functioning as a backstop to the transfer pricing rules. Consistent with this sentiment, I would describe the case as one of beneficial redundancy.

Consider first the case that the FBCSI rules are meant to combat. At the core we are concerned with the case where a controlled foreign company purchases property from, or sells property to, a related corporation where the property is manufactured and sold for use or consumption outside of the CFC's country of incorporation. A simple picture of the core transaction looks like this.



Should one understand the rules here to combat a core problem of parking or milking? It is, of course, *possible* to view this as a parking problem. The relevant characterization in that case, would be that we are concerned that C Corp here will retain profits and achieve a deferral benefit that is fundamentally in tension with the balance between competitiveness and tax base preservation that is sought under the CFC rules. This is not, however, the best characterization of the problem. As the rules are structured, the inclusion will generally only kick in where C Corp's activities are insubstantial. This suggests generally that *if* the parties are all fairly compensated (*i.e.*, at arm's length) there should not be all that much profit in C Corp in the first place, thus greatly reducing the need for a current inclusion rule. Conversely, *if* there is abusive pricing then one could encounter the case of substantial profits in C Corp. That is another way of saying that these particular rules seem more directed towards a milking problem than a pure parking problem. (Of course, the taxpayer only benefits from abusive pricing if it is willing to leave the shifted profits offshore, but that prospect only arises in the first place because of the pricing.) Thus we have a classic case of redundancy.

As an aside I would observe that not all aspects of subpart F are alike in this respect. A nice contrast here would be the foreign personal holding company income rules. Unlike the FBCSI rules one can easily construct cases where even with legitimate arm's length pricing, a core parking problem continues to exist. This follows from the simple fact that the sorts of inclusions driven by these rules typically relate to the ownership of some property by the CFC. Such ownership can give rise to very substantial retained offshore earnings -- even where the property was acquired for a fair price and where the subsidiary does little in the way of substantial activity. To be sure, the problem becomes worse with abusive pricing, but the core problem can be generated by parking only, without any milking.

I would like to suggest further that one should view this as a beneficial case of redundancy. We see here the use of a parking remedy to get at a milking problem, in conjunction with the underlying milking rules. The benefit derives from the fact that it is far easier to apply the general terms of the FBCSI rules (which look to readily identifiable factors) than it is to make a pricing adjustment under the transfer pricing rules.[14] I think there is a general lesson to learn from this. The reason the redundant solution is a good one here is that it is possible in this case to write a general rule describing a class of cases where substantial profit is likely to arise only where there is pricing abuse. If that is the case, then it is far easier to use a current inclusion remedy than to mess around with price adjustments. The key feature, it would seem, is that the basic case involves one where the controlled foreign company does very little or nothing and does not own valuable property. Where those factors do not hold, matters will become more complex, essentially because one cannot just assume that the bulk of the profit is from pricing abuse and thus we need to use a milking-style

14. This statement becomes less true in instances where there are disputes about whether the taxpayer has satisfied the manufacturing exception.

remedy, with its focus on prices or profit explicitly, in order to separate out the actual milking problem.

We can close with one further observation about statutory redundancy. I have just argued that FBCSI is a case of good redundancy involving a parking remedy applied to a milking problem. The two factors that drive the beneficial aspect here are (i) the ease of application of parking remedies compared to milking remedies and (ii) the fact that it seems possible to identify a milking abuse without undertaking the generally difficult analysis of prices which are the constituent elements of the milking abuse. This suggests why redundancy running in the *opposite* direction is unlikely to be beneficial. Thus one *can* use a milking remedy to get at a core parking problem. But it is difficult to see when or why this would be optimal. First, ease of application runs in the opposite direction, as price or profit analysis under the arm's length standard will always be more difficult and cumbersome than a representative analysis under the CFC rules. Second, it is difficult to see how one can identify a *core* parking problem through the application of milking rules. This follows from the fact that parking rules are constitutive of the base and describe at the core instances where there is no pricing abuse. The best case one could make here is that in the face of statutory CFC rules that struck the base preservation/competition balance in the wrong place -- by permitting too much deferral -- one can move matters back in the correct direction through price adjustments. Despite the directional correctness, this is a very poor way of getting to the best place regarding the underlying parking problem. Direct modifications to the CFC rules through provisions that do not analyze price or profits would seem preferable.

C. Excess Returns from Intangibles Transfers.

The milking versus parking dichotomy is potentially helpful in analyzing the debates surrounding the Obama administration's proposals for modification to the subpart F rules to require current inclusions for "excess returns" from intangibles transfers. This proposal would identify excess returns by comparing the excess of gross income over allocated costs increased by (an as yet unspecified) percentage mark-up. If the effective foreign tax rate is below 10%, then the excess return portion would be subject to full inclusion. That full inclusion result would phase out as the effective tax rate increased from 10%-15%.[15]

Critics of the proposal have characterized it as an attempt to bring a back door formulary approach to the table, even though this is broadly inconsistent with the arm's length standard under section 482.[16] The administration has defended the proposal on the grounds that it is a timing provision rather than a transfer pricing or allocation provision.[17]

Within the framework developed here I think there are two basic ways in which one could characterize the proposal. One characterization is that the proposal is meant to address a parking problem at the core but that it has a further tangential effect on a milking problem. The alternate characterization is that the proposal is all about using a parking remedy to combat a milking problem. Moreover, although each of these characterizations involves an element of redundancy, the view one takes regarding whether such redundancy is harmful or not will likely depend, to some extent, on the appropriate characterization. We don't have all that much to go on here, so I think the best that one can do is to sketch the alternate stories and point to supporting evidence.

Consider first the characterization whereby we take the provision to be about a core parking problem. The idea here is that the provision is about redefining the base, irrespective of pricing abuses. Clearly there is conceptual space for this category. That is, the provision may well lead to

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15. *See* Treasury Dep't., *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* 88-89 (2012) [hereafter 2013 General Explanations].
16. *See, e.g.,* Dolores Gregory, *Professor Calls Excess Return Proposals a 'No Confidence' Vote on Transfer Pricing*, INTERNATIONAL TAX MONITOR (Apr. 16, 2012) (reporting comments of Professor Steines on excess returns proposal).
17. *See* Dolores Gregory, *Corwin Defends Excess Returns Proposal But Says 'Design' Still Up for Discussion*, INTERNATIONAL

inclusions where there is *no* violation of the arm's length standard. Moreover, on this view this fact is no condemnation of the proposal, which is not supposed to be designed to combat pricing abuses in any event. Indeed, on this characterization this fact about scope of application is arguably a positive attribute, as it confirms the very fact that this is not meant to be a pricing provision. In terms of whether this is a good characterization of the proposal I suppose one might point to three items of relevance. First, as a pure base definition provision it arguably makes good policy sense. If one can accurately measure "excess returns" as reflecting economic rent then this is a portion of the base that can be taxed without adverse effect on competitiveness of home country firms. (Although one would have to take account of effects on future incorporations and inversion activity.) Second, to the extent that the problem is generated by the conjunction of cost sharing intangibles plus navigation around the FPHCI royalty rules, the provision looks like it is attacking a core problem about base definition rather than problematic pricing. Third, at least some (though not all) statements from the administration itself seem to favor this characterization.[18]

The alternate characterization is that this is all about pricing. Specifically, against the backdrop of difficult to administer and enforce transfer pricing rules, the provision should be understood as a formulary backstop. As above, there are several points that favor this characterization. First, arm's length transfer pricing for difficult to value intangibles does present intractable administrative problems. Thus some would favor a shift to greater reliance on formulary methods, which is consistent with the proposal. Second, the administration itself has cast the provision in this way. Thus the Green Book would seem fairly clear on the point. In describing the reason for change from current law, the explanation states: "The potential tax savings from

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TAX MONITOR (Apr. 12, 2012).
18. *See id.*

transactions between related parties, especially with regard to transfers of intangible assets to low-taxed affiliates puts significant pressure on the enforcement and effective application of transfer pricing rules."[19] This view has been echoed by a range of commentators.

How should these characterizations bear on whether one views this proposal as involving an instance of good or bad redundancy? One aspect of this evaluation, at least, seems to be clear. It is no valid criticism to observe that there is some overlap (that is, some aspect of redundancy) and that the CFC approach is formulary and thus in tension with arm's length principles. The problem with that critique is that it would run in every case where there is some overlap between the CFC and transfer pricing regimes. CFC regimes are "formulary" by their nature. For example, consider the FBCSI rules discussed in the previous section. These rules too essentially follow a formulary approach, albeit one with the extreme outcome of 100% of the defined class of net income subject to current inclusion. A sounder way to assess the merits of redundancy follows the tack above, which is to inquire about the potential for drafting general rules that capture pricing abuses, without having to assess the arm's length character of the actual prices.

If this is the relevant criterion, though, it plays out differently under the two rival characterizations of the excess returns provision. If we understand that provision to be essentially about base definition, then it is difficult to make out the case for harmful redundancy. In any case where there is *no* abusive pricing then the provision functions, by definition, to expand the base in the way it was meant to. And in any case where there is abusive pricing which is picked up by the rules this is like a bonus and would appear to be beneficial. By contrast, if one views the provision, as suggested by the Green Book, as a transfer pricing backstop from the outset, then one faces a series of complicated questions about drafting rules in the correct way. This particular provision is

19. *See* General Explanations, *supra* note 15, at 88.

not sufficiently specific to undertake an evaluative inquiry. Even so, one can readily identify the relevant aspects here, such as the determination of the percentage mark-up, that should be relevant.

D. Expansion of Intangibles Category under Section 482.

A final issue I consider here relates to proposals to expand the category of recognized intangibles under section 482. Thus the Obama administration has proposed for several years now that the "intangibles" category be expanded to include residual items, such as goodwill and going concern value. More radical shifts, which would contemplate recognition of something like a synergy rents intangibles to reflect the gains from organization, have been mentioned as a possibility by the OECD. I'll refer to these two sorts of potential intangibles as a residuals intangible and a synergies intangible, respectively. The introduction of either would be a clear departure from current US law, which generally contemplates only the recognition of separately transferrable intangibles.[20] Each of these can be analyzed within the context of the milking versus parking dichotomy. First, though, it helps to have an analytical understanding of how a residuals intangible and a synergies intangible relate to one another. One way to understand the relationship is that a residuals intangible would reflect the fact that a firm has value over and above the value it can realize from transferring individually transferrable assets in isolation, even if each of those individual transfers receives an arm's length price. The synergies intangible, by contrast, would reflect the fact that even once you take account of the residuals issue (by, for example, capturing what premium would be paid if all assets were transferred together), there is a further problem that arises from the fact that there are

20. For a detailed discussion of this issue see Jens Wittendorf, *Transfer Pricing and the Arm's Length Principle in International Tax Law* 601-10 (2010).

gains from organization where firms are under common control, which are literally impossible to price under the arm's length standard.[21]

Let's consider the residuals intangible first. Should we understand calls for such an intangible as responding to a milking problem or a parking problem? One *could* view this as responsive to a milking problem, but this ultimately is not that persuasive. There are two logical possibilities here. One is that there is a view that the existing transfer prices for separately transferrable assets are not representative of the prices that would be demanded at arm's length for the assets -- even in isolation. This is a plausible statement of an underlying problem given the extreme difficulties in general that follow from identifying good comparables. But the introduction of a residuals intangible would have to be seen as a very bizarre solution to this problem. If we are unable to identify good arm's length prices for certain assets in isolation, then surely we will do all the worse if we try to break out an element of value reflecting the aggregation of the already difficult to value assets. Put another way, the introduction of such an intangible could never increase the amount of information on the table regarding good arm's length prices because the residuals cannot, by definition, be transferred independently. The only data available will be that regarding assets that are in fact transferrable and the current framework can already account for all of this data.

The second possibility is that the prices of each individually transferred asset is failing to take account of the gains from the aggregation of such assets. Again, this is a plausible problem but it is difficult to see how anybody could think that introduction of a residuals intangible could address this. For the reasons just mentioned, there can be no direct search for comparables reflecting this

21. That basic critique is often referred to as the "continuum price problem." *See* Langbein*, supra* note 3. The idea is that any set of prices that splits the premium from organization is equally legitimate under the arm's length standard. As I have described it in the text, the residuals intangible and the synergies intangible each represent a sort of gain from aggregation of assets. I have developed the relationship between these categories at length in other work and thus do not

residual value component. Thus a far better approach would seem to be one that is already contemplated under existing law, which is the way in which one may aggregate transactions under arm's length transfer pricing generally.[22]

In light of these issues it seems that a sounder interpretation of calls for a residuals intangible is that it represents an attempt to redefine the base. Put crudely, even with condoned pricing, such as that which will follow an accepted cost sharing agreement, a residuals intangible will give the government a chance to try to pull part of the base back into the U.S. In the terms used here, it looks like a milking remedy deployed to defeat a parking problem (perhaps created, as above, by overly permissive CFC rules under provisions such as the active royalty exception). Thus we have a case of using transfer pricing to adjust the base definition rather than the CFC rules. It reflects an attempt at statutory parsimony but likely a quite ill advised one given the predictable difficulties and conflict that will arise from attempting to price the residuals intangible.

We can now turn to consideration of a synergies intangible. I speculate that one reason that proponents of the arm's length standard might be tempted to introduce a synergies intangible is to shore up the standard against the charge that the continuum price problem is an "inherent flaw."[23] That is, the hope might be to at least identify the relevant premium and ensure through some method of allocation that it is taxed once, rather than zero or two times.

This again looks like a milking solution applied to a problem of parking (i.e., constitutive base definition). For the reasons mentioned above regarding the unavailability of comparables it is difficult to see how this could possibly be a good approach. Further, what I would like to suggest

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go into it here. *See* Mitchell A. Kane, *Transfer Pricing, Integration and Novel Intangibles: A Consensus Approach to the Arm's Length Standard* (manuscript on file with author).

22. For a general discussion, see Wittendorf, *supra* note 20, at 343-63.

23. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 34 (2010).

here is that one should view this case as *not* actually presenting a problem insofar as existing law actually has a framework within which one can analyze the synergies issue. In other words there actually is no "inherent flaw" here. I focus here on the *unilateral* meaning and import of section 482 -- that is, outside of the treaty context.

The crucial distinction between treaty and non-treaty cases for present purposes is the way in which the former involves the use of the arm's length standard to constrain *states* in the way they make adjustments to stated profits (of residents of the treaty partner) versus the way in which the latter involves the use of the arm's length standard to constrain *taxpayers* in the way they allocate income against the backdrop of existing domestic law. This distinction is crucial for the different ways in which the arbitrariness of the allocation of profits from synergies comes to bear.

As a strictly economic matter, it seems that the "inherent flaw" argument gains some traction. That is, there is no well founded sense in which the synergy gains belong to one commonly controlled entity versus another. Scholars have analogized this issue to that of a bilateral monopoly.[24] For any two corporations under common control that generate a synergy premium, there is no theoretically determinate way to allocate the gain across the entities. The "inherent flaw" arguments tells us that one cannot solve this problem by looking to comparable entities.

But law is not economics. Law provides the starting point which we lack in the strictly economic analysis. Or, at least it does so in the non-treaty case. In that case we are not using the "arm's length principle" as a doctrinal concept to set the allocation between jurisdictions in the first instance. This is the import of my repeated statement that section 482 is not constitutive. That allocation is already achieved under domestic law. This provides a solution to the allocation of profit from synergies *without* falling back on arm's length principles and the theoretical indeterminacies that are supposed to be endemic to it. This point is best appreciated on the margin. Consider two entities operating at arm's length, each entirely within a single country. Now suppose the entities come under common control and the joint enterprise begins to realize gains from integration, which for these purposes can be attributed to what I am calling the synergy intangible. My point here is that absent a treaty each jurisdiction can be expected to take some approach to allocating profits. Each jurisdiction, that is, will have some approach to allocating income of the home enterprise abroad (in which case it then may either exempt or grant a credit for foreign taxes paid) and some some approach to allocating income of the foreign enterprise to the home country, thereby opening up the prospect of source based taxation. The arm's length principle constrains taxpayers from setting prices across the enterprises in a way that would thwart these allocations. But the allocations already may be present under domestic law. Crucially this applies to synergy gains.

Suppose that a country has some set of domestic rules that determines allocation of the tax base in the first instance *without* reference to an arm's length principle. This is essentially the approach of the United States. Take the case again of two commonly controlled entities. For the base of the United States company in the first instance this will be a function of the amount of any allowable foreign tax credit, which is ultimately determined by a set of autonomous source rules which do not derive from the arm's length standard. For the foreign subsidiaries the US portion of the base will be determined as a combination of domestic threshold considerations, source determinations (again under autonomous source rules), the analysis of certain factual connections between US located activity and the income. Again, these determinations make no reference to the arm's length standard on the margin. As already noted these sets of rules give us a way to allocate

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24. Wolfgang Schön, *International Tax Coordination for a Second Best World (Part I)*, 1 WORLD TAX JOURNAL 247-48 (2010).

income and expense, on the margin, as we confront incremental integration (and the synergy gains that are supposed to follow.) Although this may stretch matters somewhat let's now imagine that we take the resulting allocations, including of the synergy gains, that result in this way are in some sense a first best. This is not to say that they are optimal but they are the jurisdiction's preferred method of allocation. They represent, under enacted domestic law, the sovereign's view of a clear reflection of the geographical allocation of tax base. However, the sovereign now confronts the problem that the taxpayer may be able to distort the result of such allocation through manipulative pricing, to the extent that we respect the separate entities in the first place. This, I think, frames the issue nicely. Such a jurisdiction would now have a choice about what to do. It could for example implement something like an arm's length standard, rewriting the taxpayer's price in an attempt to get back to the ideal. Or, the concerns about pricing could be so severe that the sovereign could scrap the system altogether, ignore the corporate boundaries and proceed with unitary apportionment.

For me this then poses an empirical question. Which approach gets the sovereign closest (and one can take account of administrative costs here). From this standpoint the "inherent flaw" of the arm's length standard has no particular bearing because it is not achieving the allocation in the first instance. If the arm's length approach did come closer as an empirical matter it would be strange indeed to reject it on the grounds of the inherent flaw. Now, of course it is possible that the country's first choice approach is a formulary one that took no account of arm's length pricing, rather than stacking arm's length adjustments on top of some other set of allocation methods. But that is not the case under discussion. The question rather, is the import of the "inherent flaw" argument where a country has chosen to shore up the first choice allocation with that method, in which case my basic claim stands. The critique gains no traction here. I should mention a number of limitations and caveats.

First, the argument presented here regarding the import of the fundamental critique in the non-treaty case has merit only insofar as there *is* an independent basis under domestic law to allocate profits without reference to the arm's length principle. Such an independent basis exists under US law, as just discussed, because the US approach to allocation is unhinged from the general treaty approach to the question. But the US would seem to be something of an outlier here. Many countries essentially apply the treaty PE concept to make threshold determinations about taxability and use a treat concept of attributable profits to allocate tax base. To the extent a country takes such an approach and to the extent that the endorsed treaty approach is itself governed by the arm's length principle then this argument cannot run.

Second, my analysis above which seeks to address the synergy rents problem by falling back on prior domestic law allocations of such rents does not account for asset transfers among commonly controlled parties. That is, I analyze the case on the margin as firms achieve incremental integration but without any asset shifts. Surely, this ignores the very crux of the problem, which is that taxpayers can gut the resulting allocations under the existing domestic non-arm's length standards by transferring valuable intangibles to other jurisdictions with salutary effect under the domestic allocation rules. If the issue is one of *transfer* of valuable assets, though, then we are back in the case discussed above with the residual intangible. We need some sensible approach for such transfer but, even if difficult, this will not implicate the inherent flaw. For any existing allocation of assets across commonly controlled firms we can consider incremental integration on the margin and then potentially solve the allocation problem for returns from integration under domestic law without resort to comparables or arm's length principles. If that is the case then the inherent flaw problem is no problem at all. Introducing a synergies intangible, then, is perhaps best understood neither as redundant nor parsimonious. It is more like the case of killing a non-existent bird with one stone. A result that surely ought to be avoided.

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Conclusion

The CFC and transfer pricing rules under the Code address problems which are sufficiently similar that it is often possible to use one set of remedies to address the other set of problems. In this comment I have tried to suggest that we think twice before leaping to the conclusion that this is a good outcome. A more nuanced approach requires identifying the core problem one is trying to fix and then examining the actual fit between proposed solution and purported problem.