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Christopher Capuzzi

I. INTRODUCTION

The increasing globalization of companies is indisputable, and the multinational enterprise offers many heuristic challenges. Among these are jurisdiction-specific taxation and accounting standards and principles. Enterprises often operate without regard to legal entity structures but rather along business lines. While entities may operate without regard to jurisdictional lines, local taxing and accounting regimes are steadfast on ensuring adherence to their respective principles. Chief among these is ensuring that there is a proper allocation of the tax base. The proper allocation of the tax base has long been at the forefront of concerns, so much so that normative transfer pricing principles have existed for decades. However, the “variation in tax rules across national tax jurisdictions causes different degrees of complexity and uncertainty for both the tax authority and the taxpayer regarding tax base allocation.”

Pharmaceutical giant GlaxoSmithKline PLC’s $3.4 billion 2006 settlement with the United States Internal Revenue Service (I.R.S.) demonstrates the importance of the proper allocation of the corporate tax base. The settlement was the largest in the I.R.S.’s history and resolved a nearly two-decade long transfer pricing dispute between the I.R.S. and Glaxo’s American subsidiary in its dealings with the British parent

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1 E.g., Paul Hannon, World Factory Output Falls, Clouding Recovery, WALL ST. J., Aug. 10, 2004, at A2 (discussing that widespread industrial output decreases in 2004 suggest that “globalization is increasing the degree of synchronization in the world economy . . . ”).
3 Id.
company.

Moreover, the International Accounting Standards Board (IASB) is working with the chief accounting standard setter in the United States, the Financial Accounting Standards Board (FASB), to converge U.S. Generally Accepted Accounting Principles and International Accounting Standards. Nonetheless, the FASB’s Interpretation Number (FIN) 48 is wholly inapposite to principles based accounting. This provision concerns the recordation and measurement of an entity’s uncertain tax positions and creates unique challenges for entities that must deal with transfer pricing.

The purpose of this Comment is to propose a process whereby the taxpayer or financial statement preparer can minimize uncertainty in preparing its FIN 48 analysis for transfer pricing positions through the I.R.S. Advanced Pricing Agreement process. At present, divergent doctrines and standards set forth by the I.R.S. and the FASB create complexity and inefficiency for the taxpayer or financial statement preparer.

Part II examines the definition and historical underpinnings of transfer pricing and also illustrates the operation of transfer pricing. Part III looks beyond the United States and covers methodologies employed among foreign jurisdictions in carrying out transfer pricing systems. Part IV analyzes the complexities that are inherent in transfer pricing as well as programs that have been implemented to mitigate these intricacies. Part V introduces FIN 48 and its application to financial statement preparers. Part VI examines FIN 48’s impact on transfer pricing and the addition of yet another nuance to the transfer pricing puzzle. In Part VII a new proposal is introduced in an attempt to harmonize FIN 48 and transfer pricing.

II. TRANSFER PRICING: DEFINITION AND HISTORY

In a broad sense, “transfer pricing refers to the pricing of goods, services, capital and technology inputs, managerial skills, financial services, shared/support services, etc. if they are transferred between affiliates of [a multi-national enterprise].” It includes the prices a multi-national enterprise charges its affiliated entities for goods or services that are transferred within the enterprise. Corporations often operate without

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6 Brem & Tucha, *supra* note 2, at 115.

7 See ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, ¶ 11 (hereinafter OECD TRANSFER PRICING GUIDELINES); Barry Freeman, *Recent Developments in Transfer Pricing Create Uncertainty for Multinational Corporations*, 15-4 METRO. CORP. COUNSEL 30 (2007) (“Transfer pricing is the area of tax law that deals with the allocation of income resulting from transactions between commonly controlled parties.”); J. Scott Wilkie,
regard to jurisdictional boundaries and shift goods, services, knowledge, and other tangible and intangible assets from one part of the organization to another. At first glance, such a distribution scheme may simply seem to be the result of economic principles and an efficient use of resources. But lurking behind the scenes, tax arbitrage opportunities often pervade such transactions.

An example from Eduardo Baistrocchi’s *A Global Proposal for Simplification* provides a simple illustration of how and why such a transaction takes place. Assume that X is a manufacturer of cars and a resident of France. X Sub is its wholly-owned subsidiary resident in Great Britain, which resells the cars to independent customers in that country. The taxable income of the subsidiary is determined by three variables: (1) the reselling price of the cars to independent customers, (2) the expenses paid for all its inputs (except for the cars), and (3) the expenses incurred for purchasing the cars from the manufacturer. The market generally determines the first two variables. Conversely, the third variable is entirely under the manufacturer’s control. Therefore, if the tax rate of the manufacturer’s jurisdiction, France, is higher than that of its subsidiary, Great Britain, the manufacturer can charge the lowest possible transfer price to its subsidiary in order to channel the profits of the multinational enterprise to the subsidiary’s jurisdiction. On the other hand, if the tax rate applicable to the manufacturer is lower than that of its subsidiary, the manufacturer can charge the highest possible price to its subsidiary. The net effect of this transfer pricing strategy is to increase the global after-tax return of the multinational enterprise by shifting the profits to the most favorable tax jurisdiction.

Transfer pricing rules seek to normalize the effects of a commonly controlled enterprise’s tax manipulation and place it on parity with the income that would have been earned had the company been operating as a true stand-alone entity and not part of a controlled group. To that end, countries worldwide are concerned that they are receiving an equitable share of a controlled entity’s tax base and impose significant penalties on transfer pricing adjustments.

Internal Revenue Code Section 482 permits the I.R.S. to allocate

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Donald Wilson, William D. Rohrer, & Matthew T. Staab, *International Taxation*, 41 INT’L LAW. 581 (2007) (“Transfer pricing concerns the measurement and allocation of international income within a commonly controlled corporate group among group members who make functional contributions to the earning of that income and have undertaken risks with respect to how that income is earned.”)


9 *Id.* at 949–50.

10 Wilkie et al., *supra* note 7, at 586.

11 I.R.C. § 482 (2000):

In any case of two or more organizations, trades, or businesses (whether or not
gross income, deductions, and credits between related taxpayers to the extent necessary to prevent evasion of taxes or to reflect clearly the income of related taxpayers. Section 482 serves two functions. First, it prevents a shifting of income to more tax favorable jurisdictions. Second, in the international setting, even if the intercompany transactions did not result in an overall reduction in the tax burden of the controlled group, the I.R.S. can invoke Section 482 to allocate income to the United States to ensure its appropriate share of tax revenue.12

The power of the I.R.S. to allocate income is not a new concept. As far back as 1917, the Commissioner was authorized to allocate income and deductions among affiliated corporations.13 The Revenue Act of 1921 contained the first version of what has become section 482.14 In the 1928 Act, the Commissioner’s authority was significantly expanded and was “expressly predicated upon his duty to prevent tax avoidance and to ensure the clear reflection of the income of the related parties.”15

For decades, the small number of multi-national enterprises meant that section 482 and its predecessors had little impact in the international taxation arena.16 Regulations that were first issued in 1935 remained largely unchanged until 1968.17 The regulations promulgated that an arm’s length standard be applied in determining true taxable income.18 However, these regulations did not mandate a particular allocation of income method with the result that the predecessors of the current section 482 were used broadly to challenge a variety of tax avoidance schemes.19 With no clear directive, the courts applied a number of different standards to determine if

incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B) [26 USCS § 936(h)(3)(B)]), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

12 PAUL R. McDANIEL, HUGH J. AULT, & JAMES R. REPETTI, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 146 (5th ed., 2005).
13 U.S. DEP’T OF THE TREASURY, REGULATIONS NO. 41 RELATIVE TO THE WAR EXCESS PROFITS TAX, IMPOSED BY THE WAR REVENUE ACT, APPROVED OCTOBER 3, 1917 arts. 77-78 (1918).
15 Id.
16 Id.
17 Id.
18 Id.
19 Id. at 459–60.
a transaction was conducted at arm’s length.\(^{20}\)

Beginning in the 1960s, Congress became aware of the increasing problem of U.S. companies shifting their U.S. income to more tax advantageous foreign jurisdictions.\(^{21}\) In 1988 the Internal Revenue Service prepared the “White Paper,” a comprehensive study of intercompany pricing rules.\(^{22}\) The 1988 I.R.S. study “was followed by proposed and temporary regulations in 1992 and 1993 . . . [with] final regulations . . . issued in 1994 . . .”\(^{23}\) Only minor modifications to the regulations have been made since the 1994 final regulations were enacted.\(^{24}\) The regulations, as enacted, again confirmed the arm’s length standard but also went a step further and established specific rules for certain kinds of intercompany transactions, including the performance of services, loans, and sales of tangible and intangible property.\(^{25}\)

Broadly speaking, the arm’s length standard is the amount charged or which would have been charged for the same or similar transaction had the transaction been executed between unrelated parties under similar circumstances considering all relevant facts.\(^{26}\) “The regulations provide specific methods to be used to determine whether transactions between related parties conform to the arm’s length standard.”\(^{27}\) The taxpayer is instructed to use the “best method” in determining which method to use to apply the arm’s length standard. Specifically, “[t]he arm’s length result of [a] controlled transaction must be determined under the method that under the facts and circumstances, provides the most reliable measure of an arm’s length result.”\(^{28}\) Furthermore, “in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm’s length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis.”\(^{29}\) For example, the regulations regarding the sale of tangible personal property set out five specific methods for determining an appropriate arm’s length price. The five methods are the comparable uncontrolled price method, the resale price method, the comparable profits method, and the profit

\(^{20}\) Id. at 460.

\(^{21}\) See id.

\(^{22}\) Id.

\(^{23}\) MCDANIEL ET AL., supra note 12, at 145.

\(^{24}\) Id.

\(^{25}\) Notice 88–123, supra note 14.

\(^{26}\) See generally Treas. Reg. § 1.482–2 (2008) (describing the arm’s length standard as applied to transactions involving services, the sale or licensing of intangible property, and the sale of tangible personal property).

\(^{27}\) MCDANIEL ET AL., supra note 12, 147.

\(^{28}\) Treas. Reg. § 1.482-1(c) (2008).

\(^{29}\) Treas. Reg. § 1.482-1(c)(2) (2008).
split method. There is also an unspecified sixth method which can be used if "it provides the most reliable measure of an arm's length result under the principles of the best method rule."

Initially there was confusion as to whether or not the I.R.S. could use section 482 simply to allocate income or if they could use it to create income. B. Forman Co. v. Comm'r and its progeny in other circuits clearly established that the I.R.S. could in fact use section 482 to create income. In Forman, the taxpayer argued that the Commissioner may not create income where none actually existed, and cited case law holding to that effect. The IRS successfully imposed an arm's length interest rate on an interest free loan between two controlled entities on the grounds that no unrelated parties would loan such large sums without interest and that to not impute interest would seriously impair the usefulness of section 482. This imputed interest rate resulted in the creation of interest income to the lender. Although Forman occurred before the enactment of section 7872, which would now likely control such a transaction, the case still stands for the proposition that the I.R.S. may use section 482 to create income and not simply reallocate it.

The Commissioner must take into account collateral adjustments under section 482. Collateral adjustments may include correlative allocations, conforming adjustments, and setoffs. Correlative adjustments involve the corresponding decrease in a member of the controlled group's income when an increase has been made to another member of the group. Conforming adjustments are those that "must be made to conform a taxpayer's accounts to reflect allocations made under section 482." For example, the creation or attribution of additional income could lead to the creation of an account receivable debit entry on the balance sheet. "If an allocation is made under section 482 with respect to a transaction between controlled taxpayers, the Commissioner will take into account the effect of any other non-arm's length transaction between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation."

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32 McDANIEL ET AL., supra note at 12, at 147.
33 B. Forman Co. v. Comm'r, 453 F.2d 1144 (2d Cir. 1972). See also Central De Gas de Chihuahua v. Comm'r, 102 T.C. 515 (1994) (imputing rent on equipment used where no rent had been charged).
34 Forman, 453 F.2d at 1156.
35 Id.
36 Id. at 1157 (5% interest rate imposed on lender of $1,000,000 interest free loan to subsidiary).
37 I.R.C. § 7872 deals with interest free and below-market loans.
38 Treas. Reg. § 1.482-1(g) (2008).
39 Id.
III. TRANSFER PRICING IN THE INTERNATIONAL CONTEXT

As mentioned above, transfer pricing is not solely of domestic concern, but rather is an increasingly pervasive issue among many foreign taxing authorities who, like the United States, are concerned about the erosion of their tax bases. The Organisation for Economic Co-Operation and Development’s Model Tax Convention on Income and on Capital (OECD Model Tax Convention) forms the basis for extensive bilateral income tax treaties between OECD member countries and OECD member and non-member countries. The OECD Model Tax Convention addresses the issue of transfer pricing in Article 9 and it too endorses an arm’s length standard. The OECD originally published Transfer Pricing Guidelines in 1979 and in 1995 it revised the guidelines. The OECD Transfer Pricing Guidelines are commonly adopted in some manner by OECD member countries in their domestic tax legislation and practices.

Many U.S. income tax treaties have provisions that allow the United States to determine the income of persons that are subject to the United State’s taxing authority. Like section 482, most of these treaties contain the arm’s length standard. “Under recent treaties, where a reallocation of income has been made by one country, the other country agrees to make corresponding adjustments to the extent that it agrees with the [United State’s] redetermination of income. To the extent that the other country does not agree with the redetermination, the two countries endeavor to reach a compromise under the general mutual agreement procedures contained in the treaty.” If no compromise is reached, the taxpayer is faced with double taxation at the international level. In order for a U.S. taxpayer to claim the foreign tax credit on an item of income that was reallocated from a foreign taxing jurisdiction to the United States and in which they did not receive a correlative adjustment, the U.S. taxpayer must face an onerous task. The taxpayer must establish that it “has exhausted its administrative remedies under foreign law in seeking a refund of the foreign

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41 Treas Reg. § 1.482-1T(g)(4)(i) (2008).
42 OECD TRANSFER PRICING GUIDELINES, supra note 7, ¶ 8; see also Baistrocchi, supra note 8, at 933 (“The OECD Model is the foundation for a network of over 2,500 bilateral tax treaties”).
43 Article 9 of the OECD Model Tax Convention provides:
[When] conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
44 Wilkie et al., supra note 7, at 586.
45 MCDANIEL ET AL., supra note 12, at 156.
taxes paid on the income so reallocated.\footnote{Id. at 157.}

Although the application of the arm’s length principle to controlled-entity transactions faces criticism, many of the OECD members widely agree that it should govern the transactions. The reason for such approval is that it provides parity for transactions entered into by both controlled enterprises as well as independent entities.\footnote{OECD Transfer Pricing Guidelines, supra note 7, ¶ 1.7.} Furthermore, the arm’s length standard most closely approximates the workings of the open market in situations where goods and services are transferred between related parties and sets the normal operation of the market as the benchmark.\footnote{Id. ¶ 1.13; see also Baistrocchi, supra note 8, at 950.}

The criticism of the arm’s length principle is certainly worth noting. Because associated enterprises often engage in transactions that independent enterprises may not engage in, such as the sale of intangibles like intellectual property, it is often practically difficult to apply the arm’s length principle to such a transaction.\footnote{OECD Transfer Pricing Guidelines, supra note 7, ¶ 1.10.} The taxing authority also faces administrative burdens in the application of the arm’s length principle. The taxpayer generally establishes the conditions for a transaction at the time it is entered into; however, the taxpayer may be required at some point in the future, often several years later, to demonstrate that the transaction is consistent with the arm’s length principle.

Additionally, the taxing authority must not only gather information from the taxpayer, but also gather information about the market at the time of the transaction and information about similar transactions several years after the transaction took place, thus creating an enormous information-gathering burden.\footnote{Id. ¶ 1.11.} Aside from the temporal complexities, the taxing authority and taxpayer often have a difficult time obtaining documentation to support the arm’s length standard because the documentation may not exist, the documentation of transactions among independent entities may be unavailable due to confidentiality concerns, the available case law may be too fact specific to allow a taxpayer to make a reasonable prediction as to a future court’s determination of whether an arm’s length transaction took place, and countless other issues.\footnote{Id. ¶ 1.12; see also Baistrocchi, supra note 8, at 944.}

The OECD Model of transfer pricing is principles-based, requiring an ex post analysis and a reliance on developed case law or the functional equivalent thereof to determine the appropriate transfer prices.\footnote{Baistrocchi, supra note 8, at 933.} Indeed the arm’s length standard is inherently principles based, unlike other mechanisms, such as the Global Formulary Apportionment Method, which has been suggested but has not displaced the widely accepted arm’s length
standard. Due to the lack of good case law and general political instability, enforcement problems and unpredictability abound in many developing countries which have imported a derivative of the OECD Model and the arm’s length standard. The lack of good case law and precedent means that the developing countries’ standard based norms, such as the arm’s length standard, remain unknowable to taxpayers.

IV. UNCERTAINTIES IN TRANSFER PRICING

The OECD has recognized the inherent complexity of transfer pricing and the potential for both the taxpayer and the taxing authority to draw the wrong conclusions from the facts presented. The OECD Transfer Pricing Guidelines ("OECD Guidelines") encourage the tax examiners in those countries which choose to adopt the OECD guidelines not to demand that the taxpayer be precise in situations where it is unrealistic to do so and also that the tax examiner be flexible in his approach. The OECD Guidelines suggest that the tax examiner take the taxpayer’s commercial judgment into account about the application of the arm’s length standard to ensure “that the transfer pricing is tied to business realities” rather than academic norms.

In connection with the 1988 “White Paper” and through efforts of the Treasury, Chief Counsel, and International Examination personnel, a questionnaire was prepared and sent to selected International Examiners asking them to identify the difficulties they were encountering in administering the transfer pricing regulations. One of the principal concerns in the administration of section 482 had been and continues to be the difficulty in obtaining pricing information from the taxpayers during an examination. In most cases the I.R.S. is either not furnished relevant information from the taxpayer or the I.R.S. encounters significant delays in receiving it. The problem is not necessarily one of the taxpayer’s refusal to furnish relevant information to the I.R.S. but rather the confusion regarding what documentation needs to be retained to support transfer pricing conclusions.

There has been an emergence of national documentation requirements implemented by many national tax authorities to enforce the internationally
accepted arm’s length pricing principle. This has not, however, relieved all confusion. Specifically, the existence of intra-company transactions associated with intangible trade often leaves both the taxpayer and the taxing authority puzzled with respect to the appropriate pricing of the individual transaction. To further complicate matters, different countries have different rules regarding what transactions need to be priced and consequently measured under the arm’s length standard. This disparity in defining the transactions that are subject to the standard therefore leaves almost all taxpayers in an unpredictable state of limbo.

Furthermore, as mentioned above, even where transactions would be subject to transfer pricing regimes, often the lack of case law and directives on the application of the arm’s length standard often leave the taxpayer unsure whether the transaction will pass the proverbial muster of the taxing authority.

The proliferation of Advanced Pricing Agreement ("APA") programs demonstrates the concern that multinational organizations have for avoiding double taxation, reducing the potential transfer pricing complexities, and the desire of the jurisdiction to resolve potential disputes ex-ante. There are at least 34 countries that have established APA programs. An APA is an arrangement between the taxpayer and the taxing authority, generally in advance of controlled related-party transactions, wherein a set of criteria for the determination of transfer pricing over a fixed period of time is agreed upon. In the case of the I.R.S. APA Program, the APA is an agreement between the I.R.S. and the taxpayer in which the parties set forth the specific transfer pricing method to use for the calculation and allocation of taxable income arising from specified transactions. "APAs are intended to supplement the traditional administrative, judicial, and treaty mechanisms for resolving transfer pricing issues." APAs often contain the method that will be used to compute the arm’s length prices, the possible comparables that will be used in determining what an appropriate arm’s length price would be, the assumptions underlying what transactions will be used in defining the tax base, and so on.

An APA is analogous to a contract between the taxpayer and the taxing authority whereby certain assumptions, principles, methods, and other taxing inputs are determined in advance and to which the taxpayer is to comply in the calculation of taxable income. The I.R.S. agrees not to seek a section 482 adjustment for a covered transaction if the taxpayer files its return for the covered year in accordance with the agreed transfer pricing arrangements.

60 Brem & Tucha, supra note 2, at 115.
61 Steven C. Wrappe & David J. Canale, Advance Pricing Agreements – A Strategic Tool in Global Transfer Pricing, 60 TAX EXEC. 193, 193 (2008).
62 Brem & Tucha, supra note 2, at 117.
63 Wrappe & Canale, supra note 61, at 193.
64 Brem & Tucha, supra note 2, at 118.
method contained in the APA.\textsuperscript{65}

There are three kinds of APAs: unilateral, bilateral, and multilateral. Unilateral APAs refer to those APAs that are between the taxpayer and the taxing authority in a single jurisdiction. Bilateral APAs govern the relationship between the taxpayer and two taxing jurisdictions. And multilateral APAs refer to APAs in which the taxpayer and more than two taxing authorities are parties to the APA. Accordingly, a unilateral APA provides no protection against the possibility of a foreign jurisdiction-initiated transfer pricing adjustment.\textsuperscript{66} Even more, the unilateral APA will likely affect the tax liability in another country due to the change computed for arm's length prices at the taxing authority level in which the APA was initiated. Non-participating countries may not be amenable to the change in the tax liability in their country and may therefore disallow the adjustment, leading to potential double taxation. Because of the double taxation problems that can arise in securing a unilateral APA, taxpayers should, and indeed most taxing authorities participating in an APA program insist, that the taxpayer seek a bilateral or multilateral APA.\textsuperscript{67}

The idea that APAs are meant to be non-adversarial lends further credence to the theory that an APA is similar to a contract. It is not a one-sided determination by the taxing authority, but rather an interactive process between the taxing authority or authorities, whichever the case may be, and the taxpayer whereby they attempt to solve some of the potential transfer pricing disputes \textit{ex ante} as opposed to \textit{ex post}. Additionally, the taxpayer saves time and costs by engaging in the transfer pricing negotiations at the APA stage rather than attempting to later defend an examination.\textsuperscript{68}

However, I.R.S. APAs have their limits in functionality. Generally, an APA is reached only on the proposed covered transactions and in some cases the APA Program may require that the scope of the covered transactions either be expanded or contracted.\textsuperscript{69} Additionally, the APA Program may determine that a subset of the proposed covered transactions should not be included in the proposed transfer pricing methodology.\textsuperscript{70} Furthermore, the taxpayer must provide data intended to show that the transfer pricing methodology meets the “best method” rule under the section 482 regulations.\textsuperscript{71} The filing of an APA request does not suspend any examination or other enforcement proceedings; nevertheless, the APA Program may coordinate with other I.R.S. activities to minimize the

\textsuperscript{66} Wrappe & Canale, supra note 61, at 193.
\textsuperscript{67} See OECD Transfer Pricing Guidelines, supra note 7, ¶¶ 4.120-131.
\textsuperscript{68} Wrappe & Canale, supra note 61, at 193.
\textsuperscript{69} Rev. Proc. 06-9, 2006-2 I.R.B. 278, § 2.04(3) (describing the manner in which a taxpayer may seek an Advance Pricing Agreement).
\textsuperscript{70} Id.
\textsuperscript{71} Id. § 2.07.
intrusiveness on the taxpayer, increase efficiency, and decrease repetitive document requests.\textsuperscript{72}

It is important to note however that the APA is just a guide and, because it is determined \textit{ex ante}, does not resolve whether or not the taxpayer’s computation of income will be accepted by the taxing authority. Rather, the legal effect of the APA is to estop the I.R.S. from contesting the application of the transfer pricing methodology to the subject matter of the APA provided that the taxpayer complies with the terms and conditions set forth in the APA.\textsuperscript{73}

In the countries where APA programs exist, APA programs are a form of a cooperative agreement, and mark a shift from an adversarial, bureaucratic taxation to a positive interaction between the taxpayer and the taxing authority.\textsuperscript{74}

\section*{V. FASB INTERPRETATION NO. 48: ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES}

Non-governmental issuers of financial statements in the United States prepare their financial statements in accordance with Generally Accepted Accounting Principles ("GAAP").\textsuperscript{75} The sources of U.S. GAAP are varied; however, the Financial Accounting Standards Board ("FASB"), the principal accounting standard-setter in the United States, promulgated a GAAP Hierarchy in order to clarify the precedence of pronouncements in the preparation of financial statements.\textsuperscript{76} The most authoritative sources of GAAP are "FASB Statements of Financial Accounting Standards and Interpretations, FASB Statement 133 Implementation Issues, FASB Staff Positions, and American Institute of Certified Public Accountants ("AICPA") Accounting Research Bulletins and Accounting Principles Board Opinions that are not superseded by actions of the FASB."\textsuperscript{77}

Within this most authoritative level, the FASB in 2006 issued FASB Interpretation No. 48: Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 (FIN 48). The accounting for taxes in general is governed by FASB Statement No. 109: Accounting for Income Taxes (FAS 109). Although the validity of tax positions is a matter

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\textsuperscript{72} Id. \S\ 2.13.

\textsuperscript{73} Id. \S\ 10.02.

\textsuperscript{74} Brem & Tucha, \textit{supra} note 2, at 124-25.

\textsuperscript{75} See 17 C.F.R. \S\ 210.4-01(a)(1) (2008) ("Financial statements filed with the [SEC] which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures, unless the [SEC] has otherwise provided.").


\textsuperscript{77} Id. \S\ 3a.
of tax law, the FASB recognized that the law is subject to various interpretations and therefore the sustainability of a particular position taken on a tax return is not always certain.\textsuperscript{78} FAS 109 does not contain any specific guidance on how to account for these uncertainties in positions taken by a taxpayer.\textsuperscript{79} As a result, diverse practices developed among taxpayers in accounting for such uncertainties.\textsuperscript{80} These diverse practices led to inconsistencies in the comparability of financial statements between taxpayers as different criteria were being used by them to determine when to recognize or derecognize such income tax position uncertainties as well as how to measure and quantify the amount of uncertainty.\textsuperscript{81} The FASB therefore felt the need to address these diverse practices and in 2006 issued FIN 48. FIN 48 defines criteria that an individual tax position must meet in order for any portion of that position to be recognized in the financial statements and then provides guidance on the measurement of such a position. Thus, FIN 48 contains a recognition mechanism and a measurement mechanism. Furthermore, FIN 48 provides new disclosures to which a filer must adhere.

1. Scope

FIN 48 applies to “all tax positions accounted for in accordance with Statement 109.”\textsuperscript{82} A “tax position” refers to any position taken or expected to be taken by a company in an already-filed tax return or a future tax return that is reflected in measuring tax assets and liabilities in the financial statements.\textsuperscript{83} The term “tax position” is broad. FIN 48 states that “tax position[s] also [encompass], but [are] not limited to: (a) A decision not to file a tax return, (b) An allocation or a shift of income between jurisdictions, (c) The characterization of income or a decision to exclude reporting taxable income in a tax return, (d) A decision to classify a transaction, entity, or other position in a tax return as tax exempt.”\textsuperscript{84} Thus FIN 48 clearly applies to any shifts in income as a result of transfer pricing adjustments.

2. Determining the Unit of Account

In order to determine what constitutes an individual tax position requiring the FIN 48 analysis, the company must first determine the “unit of

\textsuperscript{79} Id.
\textsuperscript{80} Id.
\textsuperscript{81} Id.
\textsuperscript{82} Id. ¶ 3..
\textsuperscript{83} Id. ¶ 4.
\textsuperscript{84} FIN 48, supra note 78, ¶ 4.
account" at which they will examine tax positions. Factors of the unit of account include the manner in which the enterprise prepares and supports its income tax return and the approach the enterprise anticipates the taxing authority will take during an examination. The unit of account for determining what constitutes a tax position is a matter of judgment.

Determining the unit of account is extremely important for the company. The company will apply the standards set forth in FIN 48 to the unit of account level in order to determine whether or not a tax position may be recognized and if so, what portion of that benefit is to be recognized. It is imperative that the organization understand the underlying transactions which flow through to the financial statements as each transaction may have "unique characteristics related to its transfer price, which may affect the determination of the appropriate unit of account." Additionally the manner in which the local taxing authority may examine the transfer pricing could affect the unit of account. Once the unit of account is determined, the unit of account should be consistently applied to similar positions each period. A company may deviate from the consistent application rule if the facts and circumstances indicate that a different unit of account is more appropriate.

3. Recognition and Measurement (Current and Subsequent)

After the company determines the unit of account level at which it will examine its tax positions, the company must perform a two-step analysis to determine the amount of the tax position that may be recorded in the financial statements.

The first step of the analysis is the recognition test. This step is a threshold step in which the company will only be able to record the effects of tax positions when it is "more-likely-than-not" that the position, based on its technical merits, will be sustained upon examination by the taxing authority. The "more-likely-than-not" standard is defined as a more than fifty percent likelihood. The organization must consider all the facts, circumstances, and information available to it at the reporting date in determining if the more-likely-than-not standard is met. If the position does not pass the threshold "more-likely-than-not" standard, then no amount of the position may be recognized in the financial statements.

85 Id., ¶ 5.
87 Id.
88 FIN 48, supra note 78, ¶ A9.
89 Id.
90 Id., ¶ 6.
91 Id.
92 Id.
FIN 48 includes several directives for assessing the more-likely-than-not threshold. There is a presumption that the tax position will be examined by the relevant taxing authority having full knowledge of all relevant information. Accordingly, a company cannot consider the probability that the taxing authority will not examine the position. Technical merits of a tax position derive from sources of authorities in the tax law. However, widely understood past practices and precedents of the taxing authority in its dealings with the organization or similar organizations can be taken into account when assessing the technical merits. Each tax position is to be evaluated without consideration of aggregation or offset with other positions.

Once the company determines that the position is more-likely-than-not to be sustained, the company must then determine the amount of the tax position that may be recognized in the financial statements. This step is aptly referred to as the “measurement” step. The position is “initially and subsequently... measured as the largest amount of tax benefit that is greater than [fifty] percent likely of being realized upon settlement with a taxing authority that has full knowledge of all relevant information.” This step is arduous in that it requires a company to examine the outcomes and probabilities that could be realized upon settlement. While a probability table is not mandated, “it helps a company focus on the possible outcomes.”

The use of probabilities for tax position measurement purposes is a novel concept for tax practitioners and the determination of each possible outcome requires significant judgment on the tax preparer’s part. The company records a FIN 48 liability for the amount of the tax position that does not survive the two-step process. FIN 48 not only requires a significant amount of work in order to determine the initial recognition and measurement of the tax position but also requires a continual monitoring of all tax positions. A taxpayer shall recognize the benefit of a tax position in the first period that the position meets any of the following conditions: “(a) the more-likely-than-not recognition threshold is met by the reporting date, (b) the tax position is effectively settled through examination, negotiation, or litigation, (c) the statute of limitations for the relevant taxing authority to examine and

93 Id. ¶ 7.
94 FIN 48, supra note 78, ¶ B19.
95 Id.
96 Id.
97 Id.
98 Id. ¶ 8.
100 Id. at A-402–03.
101 Id.
challenge the tax position has expired.” In determining effective settlement, the FASB directs the taxpayer to evaluate whether the taxing authority has completed its examination procedures, whether the taxpayer intends to appeal or litigate any aspect of the tax position, or if it is remote that the taxing authority would examine or reexamine any aspect of the tax position. The taxpayer is instructed to assume that the taxing authority has full knowledge of all relevant information and, in light of this knowledge, the taxing authority’s policy on reopening closed examinations combined with the facts and circumstances of the tax position. Effective settlement must be considered on a position by position basis. Perhaps more intrusive is the fact that an organization must continue to monitor positions that it considers to be effectively settled. The reason for this continual monitoring is that in the event the organization becomes aware that the taxing authority may examine or reexamine the tax position or intends to litigate an aspect of it, the position is no longer considered effectively settled.

Conversely, a company is required to derecognize a previously recognized tax position when the position no longer meets the more-likely-than-not threshold. Furthermore, changes in judgment that lead to subsequent recognition, derecognition, or measurement should result from the company’s evaluation of new information and not from a new evaluation or interpretation of information that was available in a previous reporting period.

4. Classification and Disclosures

The new pronouncements require that an entity whose tax positions necessitate FIN 48 adjustments report a liability for the difference between the amount of the position and the amount that survives the FIN 48 analysis. Accordingly, these differences are called “unrecognized tax benefits” as they are tax positions taken by the organization which cannot be recognized for financial statement purposes. The unrecognized tax benefits are classified as a liability which shall not be combined with other deferred tax assets and deferred tax liabilities.

102 FIN 48, supra note 78, ¶ 10.
104 Id.
105 Cf. Id. ¶ 5.
106 Id. ¶ 6.
107 Id. ¶ 12.
108 Id.
109 FIN 48, supra note 78, ¶ 17.
110 Id.
FIN 48 requires a series of disclosures at the end of each annual reporting period. One of the most controversial of these disclosures is the required tabular reconciliation of the total amounts of unrecognized tax benefits at the beginning and end of the period.\footnote{Id. ¶ 21(a).} This reconciliation must include the gross amounts of the increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period, the gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period, the amounts of decreases in the unrecognized tax benefits relating to settlements with taxing authorities, and the reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations.\footnote{Id.} Also required in the disclosures are the total amounts of unrecognized tax benefits that, if recognized, would affect the effective tax rate, the total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position, any potential significant increases or decreases in unrecognized tax benefits, and a description of tax years that remain subject to examination by major tax jurisdictions.\footnote{Id. ¶ 21(b)-(e).}

VI. FIN 48’S CREATION OF COMPLEXITY IN THE TRANSFER PRICING ARENA

One of the principal contentions with FIN 48 and transfer pricing concerns the evaluation of each tax position without concern to any aggregation or set-offs.\footnote{Id. ¶ 7(c).} The regulations under section 482 specifically allow for aggregation of transactions: “the combined effect of two or more separate transactions (whether before, during, or after the taxable year under review) may be considered, if such transactions, taken as a whole, are so interrelated that consideration of multiple transactions is the most reliable means of determining the arm’s length consideration for the controlled transactions.”\footnote{Treas. Reg. § 1.482-1T(g)(4)(i) (2008).} This regulation is in stark contrast to the explicit FIN 48 requirement that positions are to be evaluated without regard to aggregation. Effectively, the taxpayer is forced to consider a multitude of transactions at the individual level or, conversely, must reevaluate the unit of account.

As mentioned above, the regulations also allow set-offs. If a section 482 adjustment is made, the Commissioner will consider other arm’s length transactions, provided that the taxpayer complies with certain guidelines in the regulations, which will result in a set-off against the original section 482 adjustment.\footnote{Treas. Reg. § 1.482-1T(g)(4)(i) (2008).} As with aggregations, FIN 48 conversely requires a position-
by-position analysis.

Treasury Regulation § 1.6662-6 imposes significant penalties on taxpayers who have a substantial valuation adjustment under the section 482 transfer pricing rules. The penalties range from 20 percent to 40 percent of the underpayment. The regulations do provide an escape route from such severe penalties. Under the regulations, a taxpayer will not be assessed a penalty on any portion of the underpayment where the taxpayer used a “specified method”, as defined in the regulations under section 482 for calculating the arm’s length prices, and where the taxpayer met specific documentation requirements.117 Interestingly, the level of confidence required under the regulations is not as strict as FIN 48’s more-likely-than-not standard. The regulations require that the “taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm’s length result under the principles of the best method rule” in section 482.118 A reasonable conclusion is met if the taxpayer made a reasonable effort to evaluate the potential applicability of the other specified methods.119 The regulations provide suggestive criteria in determining whether a reasonable effort was made.120

In addition to having concluded that the method was reasonable, the taxpayer must also maintain sufficient documentation to establish that the taxpayer reasonably concluded that the method and its application provided the most reliable measure of an arm’s length result.121 These documents must be in existence contemporaneously with the filing of the tax return.122 The significance of this anti-penalty provision is that the taxpayer is relieved of the possibility of having a significant transfer pricing penalty imposed while, anomalously, still subjecting the taxpayer to the possibility that the tax position does not exceed the more-likely-than-not threshold of FIN 48. Thus while no tax-related penalty is imposed, the taxpayer remains vulnerable to the possibility that its financial statements will be deemed not in accord with United States GAAP.

These divergent standards create additional work for the tax preparer. Although the documentation and the relevant analysis may satisfy penalty provisions, the taxpayer is left in the precarious position of possibly having to perform more work to assure himself that he has exceeded the more-likely-than-not threshold and the amount of the position that has a greater than 50 percent cumulative probability of being sustained.123 Accordingly,

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119 id.
120 id.
122 id.; see also Freeman, supra note 7.
the taxpayer may have to undertake the arduous task of recomputing the arm’s length prices because what may satisfy the reasonable “best method” may not necessarily be the only method that should be considered under FIN 48.\textsuperscript{124}

Even though a multinational enterprise’s intercompany transactions may fall within an arm’s length range of results, an uncertain tax position may still exist. “This may occur where management believes that they may ultimately settle at some other amount within or outside of the range documented.”\textsuperscript{125} Hence the mere satisfaction of an arm’s length result does not necessarily preclude the recognition of FIN 48 liability.

1. Will FIN 48 Create a Road-Map for the I.R.S.?

An area of significant concern is that the FIN 48 disclosures will create a roadmap for the I.R.S. to audit a taxpayer. FIN 48 mandates that companies disclose, for each annual reporting period, a tabular reconciliation of the total amounts of unrecognized tax benefits (UTBs) at the beginning and end of the period, which must include at a minimum certain specified items. Among the most controversial of these items required in the tabular reconciliation are the requirements that the company disclose the amount of current increases or decreases in UTBs resulting from tax positions taken the current taxable year, the amounts of decreases in UTBs relating to settlements with taxing authorities, and the reduction (and consequent recognition) of UTBs relating to a lapse of the applicable statute of limitations. Taxpayers are concerned that the I.R.S. may identify audit issues through the company’s FIN 48 disclosures.\textsuperscript{126}

Generally an independent auditor supports a client’s financial statements with workpapers. When auditing a client’s tax positions, the independent auditor prepares “tax accrual workpapers” to gain comfort over the tax positions, uncertain tax positions, and the disclosures reported by the taxpayer/client on its financial statements. The “tax accrual workpapers pinpoint the ‘soft spots’ on a corporation’s tax return by highlighting those areas in which the corporate taxpayer has taken a position that may, at some later date, require the payment of additional taxes.”\textsuperscript{127}

In United States v. Arthur Young, the Supreme Court noted that it is the responsibility of the I.R.S. to determine whether a corporate taxpayer in completing its return has stretched a particular tax concept beyond what is allowed.\textsuperscript{128} Furthermore, the court noted that records that illuminate aspects of the return, such as the tax accrual workpapers, are highly relevant to the

\textsuperscript{124} Id.

\textsuperscript{125} Id.

\textsuperscript{126} Dunbar & McEligot, supra note 86, at A-806.


\textsuperscript{128} Id. at 815.
The court held that tax accrual workpapers prepared by an independent certified public accountant were not protected by any work-product doctrine from disclosure to the I.R.S.

Arthur Young raises the concern that an independent certified public accountant’s workpapers prepared to support the FIN 48 items will be subject to I.R.S. probing and will create a roadmap for the I.R.S. to bring an action against the taxpayer. This is especially worrisome in the transfer pricing arena, an area fraught with complexity and ambiguity.

Since Arthur Young, the I.R.S. has exercised a “policy of restraint” on requesting tax accrual workpapers. However in 2002 the I.R.S. loosened its policy on self-restraint. In an I.R.S. Announcement, the I.R.S. stated that they will request the tax accrual workpapers related to certain listed transactions and to the extent that a taxpayer engaged in certain listed transactions but did not disclose them, will request all the tax accrual workpapers.

Notwithstanding the policy of restraint, the question arises as to whether or not the I.R.S. will request tax accrual workpapers on behalf of another country that may be seeking them via a treaty request. For example, suppose a country requests that the I.R.S. obtain a taxpayer’s FIN 48 tax accrual workpapers because the foreign taxing authority believes that the taxpayer has taken questionable transfer pricing positions. Will the I.R.S. pierce the policy of restraint in order to appease the concerns of the foreign taxing authority? Indeed the I.R.S. has admitted that it shares information it gathers from taxpayers from the APA Program.

FIN 48 reporting has begun revealing interesting information, including information related to APAs. FIN 48 transparency requirements have disclosed that several taxpayers’ usage of APAs has allowed them to reduce tax provisions and recognize significant tax benefits. For example, BNA’s Daily Tax Report identified Google, Inc. as having recognized a $90 million tax benefit thanks to an APA for 2003-06.

VII. A PROPOSAL FOR CHANGE

Despite its surrounding controversy, FIN 48 creates a standard to which preparers of U.S. GAAP financial statements must adhere. While certainly a departure from the desire to move U.S. GAAP towards a principles-based system, FIN 48 nonetheless puts preparers on parity when it comes to determining their uncertain tax positions. Transfer pricing, without a doubt, remains a complex area fraught with subjective

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129 Id.
determinations and is often the source of tax adjustments by the relevant taxing authority. Moreover, in the United States, divergent standards evolving from the I.R.S. and the FASB have added undue complexity for preparers of financial statements and tax returns.

When a taxpayer enters into APA negotiations with the I.R.S. and when they ultimately come to an APA agreement, incorporating a FIN 48 provision under the APA would alleviate some of the complexities and uncertainties that enshroud transfer pricing and its FIN 48 implications. Under the FIN 48 provision, the parties would agree that the choice of transfer pricing methodology will survive the more-likely-than-not standard. That is, when selecting the "best method" transfer pricing methodology, the parties will agree that there is a more than fifty percent likelihood of that position being sustained by the I.R.S. provided that the taxpayer conforms to the requirements of the APA. Furthermore, in terms of measurement, when choosing an arm's length range of results, if the taxpayer satisfies the APA provisions, it may recognize the full benefits agreed to, provided it falls within the arm's length range of results. Therefore, compliance with the APA would unequivocally satisfy FIN 48 requirements and not require additional work at the financial statement level.

The FASB should revise FIN 48 to allow the taxpayer to take transfer pricing set-offs and aggregations into account when performing the FIN 48 analysis. The disparate treatment between the I.R.S. and FIN 48 creates added work for the financial statement preparer. Since the taxing authority finds set-offs and aggregations acceptable, the FASB should also find them acceptable.

Finally, the APA agreements should be revised and include an assertion from the I.R.S. that they will not use FIN 48 workpapers and other tax accrual workpapers as a road map to adjustment. While divesting the I.R.S. of its ability to request such documents, preparers will be relieved of the burden and fear that their workpapers and disclosures may lead to significant adjustments. Assuming that international tax treaties will not be jeopardized, the I.R.S. should end the practice of disclosing the information gleaned in the APA process to foreign taxing jurisdictions.

Not only will these changes to the APA process relieve some of the inherent transfer pricing complexities associated with FIN 48, it will encourage more taxpayers to engage ex ante in a negotiation process with the I.R.S. The I.R.S. will also be able to direct its efforts to those transactions falling outside of Advanced Pricing Agreements. These proposals also further the cooperative nature of the APA program. Additionally, FIN 48's objective of consistent treatment and measurement of uncertain tax benefits will not be compromised. In fact, by directly working with the taxing authority, many uncertainties which are the object of FIN 48 will become clarified.