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A COMPARATIVE APPROACH TO DOCUMENTATION
METHODS AND AVOIDING TRANSFER PRICING
PENALTIES: IS THE UNITED STATES JUSTIFIED IN ITS
APPROACH OF ENFORCING PENALTIES UNDER SECTION
6662?

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I. INTRODUCTION

Does a multinational corporation's documentation of transfer pricing matter, and how is the Internal Revenue Service (IRS) applying § 6662 based on these methods?

This note starts off by analyzing the IRS's application of § 6662,¹ its assertion of penalties, and its approach to assessing the adequacy of transfer pricing documentation employed by multinational corporations (MNCs). This note aims to reveal whether the United States' approach to cracking down on tax evasion via transfer pricing documentation is justified in comparison to the Canadian, United Kingdom, and Australian models.

Recently, the IRS ramped up its enforcement of penalties under § 6662 for inadequate transfer pricing documentation. Cases like *Newell Brands v. Commissioner*² and *Airbnb v. Commissioner*,³ not only demonstrate the methods these MNCs used to document their transfer pricing activity, but also shed light on how the IRS reached its determinations to assert penalties under § 6662.⁴ This note takes a deeper look into the IRS's application of § 6662, its recent revival, as well as the code's relationship to transfer pricing in the IRS's assessment of what it deems as adequate transfer pricing methods⁵ employed by MNCs, as reflected in their documentation.⁶

The discussion will elaborate on technical topics and terms related to the fields of international tax law, economics, and accounting. The note will also describe (1) the scope of the situation as a legal and policy matter, in addition to (2) how tax courts have treated the issue of inadequate transfer pricing documentation, (3) how the IRS applies § 6662, (4) what this means for MNCs to adjust and evaluate their

¹ I.R.C. § 6662.

² *Newell Brands v. Comm'r*, No. 11897-24 (T.C. July 19, 2024).

³ *Airbnb, Inc. v. Comm'r*, No. 12423-24 (T.C. July 30, 2024).

⁴ Steven C. Wrappe, *IRS Transfer Pricing Enforcement Trend Calls for Self-Assessment*, BLOOMBERG L. (Sept. 23, 2024, 4:30 AM), <https://news.bloomberglaw.com/privacy-and-data-security/irs-transfer-pricing-enforcement-trend-calls-for-self-assessment> [<https://perma.cc/9RVR-BFL9>].

⁵ ODDLEIF TORVIK, TRANSFER PRICING AND INTANGIBLES: US AND OECD ARM'S LENGTH DISTRIBUTION OF OPERATING PROFITS FROM IP VALUE CHAINS, at 6 (2018).

⁶ Ronald B. Davies, Julien Martin, Mathieu Parenti & Farid Toubal, *Knocking on Tax Haven's Door: Multinational Firms and Transfer Pricing*, 100 REV. ECON. & STAT. 120, 122 (2018).

current documenting practices of their transfer pricing, and lastly, (5) highlight the similarities and differences between the United States' approach and the Australian approach, which will allow more definitive answers about whether the United States is justified as in their strategy of penalty enforcement under § 6662, or if it is completely discrepant.

II. BACKGROUND

A. *What is Transfer Pricing?*

When commonly controlled companies, subsidiaries, or affiliates of a larger company exchange goods and services, the pricing taking place within these intercompany transactions is called *transfer pricing*.⁷ The types of transactions can involve intangibles like sales, licensing, leasing, services, and interest, or other goods and services between one division of a company to another.⁸ Some reasons why MNCs engage in transfer pricing arise when there is misalignment with respect to prices set for internal transactions. Situations where prices are not closely linked to the costs of inputs or to market conditions occur when transfer pricing makes sense for MNCs.⁹ The pricing within these transactions is at the discretion of the companies but is based on valuations of anticipated profits that simultaneously account for the risks associated with development.¹⁰

Furthermore, the connection between transfer pricing and tax strategy is that it serves as a mechanism to lower the overall taxes of a parent company. The landscape looks like this: higher prices are set for divisions in high-tax countries to reduce profits, whereas lower prices are set for divisions in low-tax countries to boost profits.¹¹

Within the international context, several authorities like the Organization for Economic Co-operation and Development (OECD) have

⁷ ROBERT FEINSCHREIBER, *TRANSFER PRICING METHODS: AN APPLICATIONS GUIDE*, at 3 (2004).

⁸ *Id.*

⁹ Constantinos Challoumis, *Transfer Pricing Methods for Services and the Policy of Fixed Length Principle*, 33 *ECON. & BUS.* 222, 223 (2019).

¹⁰ A Andrea Musselli, *Uncertain Issues that Firms and Tax Administrations (the Latter, Even Each Other) Litigate in Transfer Pricing*, 49 *INT'L TAX J.* 31 (2023).

¹¹ Jack Hirshleifer, *On the Economics of Transfer Pricing*, 29 *J. BUS.* 172, 172 (1956).

established standards for transfer pricing documentation.¹² The Internal Revenue Code (IRC) also contains relevant provisions on regulating controlled transactions.¹³ The point of these standards is to make sure MNCs are not artificially shifting taxable profits to evade taxes.¹⁴ Artificial profit shifting, and tax evasion are the main issues surrounding the transfer pricing controversy associated with MNCs, particularly in the international context where tax jurisdictions vary considerably.¹⁵ Related-party transactions should be made according to the arm's length principle and any deviation from it that results in less taxes payable upon the income received is a transaction that will alert the tax authorities.¹⁶

In 1988 the IRS introduced an approach for examining the reasonableness of intercompany transactions known as the Arm's Length Standard (ALS).¹⁷ ALS functioned as a response to problems relating to the potential for tax evasion. The IRS tried to assess genuine tax liability between intercompany transactions by comparing these transactions to those between unrelated companies "dealing at arm's length."¹⁸

Section 1.482-3 under the Treasury Regulations¹⁹ contains the scope and limitations of the authority it gives the IRS to alter income

¹² See, e.g., Org. for Econ. Coop. & Dev. [OECD], *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, at 227-244 (Jan. 2022), https://www.oecd.org/en/publications/2022/01/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_57104b3a.html [<https://perma.cc/K6DF-4F2N>].

¹³ 26 C.F.R. § 1.482-3.

¹⁴ Brian Jenn, *The GloBE Knock-On Effects of Transfer Pricing and Other Adjustments*. - *EBSCO*, 50 INT'L TAX J. 3 (Jan.-Feb. 2024).

¹⁵ Glen Rectenwald, *A PROPOSED FRAMEWORK FOR RESOLVING THE TRANSFER PRICING PROBLEM: ALLOCATING THE TAX BASE OF MULTINATIONAL ENTITIES BASED ON REAL ECONOMIC INDICATORS OF BENEFIT AND BURDEN*. - *EBSCO*, 22 DUKE J. OF COMP. & INT'L LAW 425 (Spring 2012).

¹⁶ Agnes W.Y. Lo & Raymond M.K. Wong, *Tax Compliance and Audit Adjustment--An Investigation of the Transfer Pricing Methodologies*. 33 INT'L TAX J. 59, 61 (Sep. 2007).

¹⁷ Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 Va. Tax Rev. 89 (1995-1996).

¹⁸ *Id.*

¹⁹ *Supra* note 13.

of commonly controlled companies.²⁰ This section also lists the acceptable transfer pricing documentation methods for assessing the taxable income linked to a controlled transfer of tangible property under ALS as the following: (1) Comparable Uncontrolled Price ("CUP"),²¹ (2) Resale Price,²² (3) Cost Plus,²³ (4) Comparable Profits Method ("CPM"),²⁴ (5) Profit Split,²⁵ and lastly the (6) Unspecified Methods.²⁶

I. Brief Overview of each Transfer Pricing Method

The first in the section 1.482-3 list of accepted transfer pricing methods is the Comparable Uncontrolled Price (CUP) method.²⁷ The CUP method is the most straightforward and precise method.²⁸ This is also why it is the main method used by most MNCs.²⁹ In the world of intracompany transactions, this method involves setting an arm's length price according to a comparable price in a transaction between an unrelated buyer and seller.³⁰ This method focuses on whether the amounts charged in controlled transactions are comparable to the amounts charged in uncontrolled transactions according to the arm's length principle.³¹ Several factors are taken into account when deciding whether a product is comparable or not.³² To assess differences between products, the CUP has four categories: (1) No differences, (2) Minor differences, (3) More than Minor differences, and (4) Material product differences.³³ With respect to categories three and four, the

²⁰ Joel D. Bonfiglio, *Tax Planning Strategies for Multinationals under the New Transfer Pricing Regulations*, 21 INT'L TAX J. 1 (1995).

²¹ Treas. Reg. § 1.482-3(a)(1).

²² Treas. Reg. § 1.482-3(a)(2).

²³ Treas. Reg. § 1.482-3(a)(3).

²⁴ Treas. Reg. § 1.482-3(a)(4).

²⁵ Treas. Reg. § 1.482-3(a)(5).

²⁶ Treas. Reg. § 1.482-3(a)(6).

²⁷ *Supra* note 20.

²⁸ *Id.*

²⁹ Kumar Sameer & Michael Sosnoski, *Decision Framework for the Analysis and Selection of Appropriate Transfer Pricing for a Resilient Global SME Manufacturing Operation - a Business Case. - EBSCO*, 49 INT'L J. OF PRODUCTION RESEARCH 5431 (Sep. 2011).

³⁰ Lo & Wong, *supra* note 16.

³¹ Treas. Reg. § 1.482-3(b).

³² Treas. Reg. § 1.482-3(b)(2)(ii)(A).

³³ ROBERT FEINSCHREIBER, *TRANSFER PRICING METHODS: AN APPLICATIONS GUIDE* (John Wiley & Sons Mar. 2004).

CUP method is not applicable as the reliability of results reduces the more differences are found between the uncontrolled and controlled transactions.³⁴ The taxpayer's next task is to make adjustments between the uncontrolled and controlled transactions.³⁵ To this end, the taxpayer must perform an analysis of the characteristics of the potential uncontrolled transactions and compare them to the controlled transactions. Subsection B of the treasury regulation³⁶ assists in outlining the factors relevant to comparing the controlled and uncontrolled transactions: Quality of the product,³⁷ Contract terms,³⁸ Level of the market,³⁹ Geographic market,⁴⁰ Date of transaction,⁴¹ Intangible property associated with the sale,⁴² Foreign currency risks,⁴³ Alternatives realistically available to buyer and seller.⁴⁴ This method is best suited for taxpayers in the business of: extracted raw materials, harvested crops, animal products, fungible chemicals, other fungible goods, without brand name, and other fungible goods, with brand name.⁴⁵

The resale price method is the next documentation method in section 482.⁴⁶ The resale price method focuses on comparing at arm's length the gross margin of a distributor on products obtained from affiliated companies with the gross margin on products from independent sources.⁴⁷ In other words, section 482 measures "...the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not

³⁴ *Id.*

³⁵ Treas. Reg. § 1.482-3(b)(2)(ii)(B).

³⁶ Treas. Reg. § 1.482-3(b)(2)(ii)(B).

³⁷ Treas. Reg. § 1.482-3(b)(2)(ii)(B)(1).

³⁸ Treas. Reg. § 1.482-3(b)(2)(ii)(B)(2).

³⁹ Treas. Reg. § 1.482-3(b)(2)(ii)(B)(3).

⁴⁰ Treas. Reg. § 1.482-3(b)(2)(ii)(B)(4).

⁴¹ Treas. Reg. § 1.482-3(b)(2)(ii)(B)(5).

⁴² Treas. Reg. § 1.482-3(b)(2)(ii)(B)(6).

⁴³ Treas. Reg. § 1.482-3(b)(2)(ii)(B)(7).

⁴⁴ Treas. Reg. § 1.482-3(b)(2)(ii)(B)(8).

⁴⁵ Treas. Reg. § 1.482-3(c)(1).

⁴⁶ Treas. Reg. § 1.482-3(c)(1).

⁴⁷ ELIZABETH KING, TRANSFER PRICING AND CORPORATE TAXATION: PROBLEMS, PRACTICAL IMPLICATIONS AND PROPOSED SOLUTIONS (Springer Science & Business Media Oct. 2008).

added substantial value to the tangible goods by physically altering the goods before resale.”⁴⁸

If the distributor doesn't have similar products from both types of suppliers, the comparison can be made between its resale margin on items from affiliated suppliers and the resale margins of unaffiliated distributors handling similar products from independent suppliers.⁴⁹

While the resale price method allows for some variation in products, the goods involved in the controlled transaction still need to be compared with those in the uncontrolled transaction.⁵⁰ Greater product differences often reflect variations in the functions performed by the parties in these transactions.⁵¹ Although using the resale price method requires less product comparability, a closer match in products tends to yield more accurate results.⁵² For instance, if a transaction includes a valuable or unique intangible asset, product similarity becomes more crucial, and special attention should be given to ensure the comparison remains valid.⁵³

The third transfer pricing method is the Cost-Plus method where the transfer price is determined by applying a markup rate to the manufacturer's cost.⁵⁴ This method involves adding a gross profit markup to the costs incurred in producing a product.⁵⁵ To determine if the markup is at arm's length, the price charged in a controlled transaction is compared to prices in similar uncontrolled transactions.⁵⁶ The gross profit is calculated by multiplying the production cost by the markup percentage.⁵⁷ This method is particularly useful when the producer has more detailed data than the distributor and is commonly applied to the manufacturing or assembly of goods sold to related parties.⁵⁸ Like the resale price method, the cost-plus method requires comparability

⁴⁸ Treas. Reg. § 1.482-3(c)(1).

⁴⁹ KING, *supra* note 47.

⁵⁰ OECD, OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS 2017 (OECD Publishing Jul. 2017).

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ Woonghee Tim Huh & Kun Soo Park, *Impact of Transfer Pricing Methods for Tax Purposes on Supply Chain Performance under Demand Uncertainty.*, 60 NAVAL RESEARCH LOGISTICS 269 (Jun. 2013).

⁵⁵ FEINSCHREIBER, *supra* note 33.

⁵⁶ Treas. Reg. § 1.482-3(d).

⁵⁷ Treas. Reg. § 1.482-3(d)(2)(i).

⁵⁸ Treas. Reg. § 1.482-3(d)(2)(ii).

between controlled and uncontrolled parties, including an analysis of functional similarities and other relevant factors.⁵⁹ Adjustments are made for any differences, and consistent accounting practices must be followed.⁶⁰

Under the cost-plus method, adjustments can be made to account for differences between controlled and uncontrolled transactions.⁶¹ These differences are considered material if they impact the gross profit markup. Consequently, adjustments should be applied to the gross profit from comparable uncontrolled transactions.⁶²

The cost-plus method also includes a list which is relevant to the adjustment factors.⁶³ The complexity of the manufacturing process or of the assembly operations,⁶⁴ manufacturing, production, and process engineering,⁶⁵ the extent of the procurement, purchasing, and inventory control activities,⁶⁶ the testing functions,⁶⁷ selling, general, and administrative expenses,⁶⁸ foreign currency risks,⁶⁹ contract terms—such as the scope and terms of warranties provided, the volume of sales or purchases, credit terms, and transport terms.⁷⁰

In contrast to the Cost Plus and Resale Price methods, the Comparable Profits Method (“CPM”)⁷¹ applies the arm’s length principle to objective measurements of profitability that come from the activities engaged in by uncontrolled taxpayers in similar businesses and circumstances.⁷² Operating profit, or profit level indicators, rather than gross profit, is typically the key measure for assessing arm’s length behaviors.⁷³ Since it is possible for taxpayers to earn similar levels of operating profit though they differ in gross profit margins, the level of

⁵⁹ Treas. Reg. § 1.482-3(d)(1).

⁶⁰ Treas. Reg. § 1.482-3(d)(3)(ii)(A).

⁶¹ Treas. Reg. § 1.482-3(d)(3)(ii)(C).

⁶² *Id.*

⁶³ Treas. Reg. § 1.482-3(d)(3)(ii)(C).

⁶⁴ Treas. Reg. § 1.482-3(d)(3)(ii)(C)(1).

⁶⁵ Treas. Reg. § 1.482-3(d)(3)(ii)(C)(2).

⁶⁶ Treas. Reg. § 1.482-3(d)(3)(ii)(C)(3).

⁶⁷ Treas. Reg. § 1.482-3(d)(3)(ii)(C)(4).

⁶⁸ Treas. Reg. § 1.482-3(d)(3)(ii)(C)(5).

⁶⁹ Treas. Reg. § 1.482-3(d)(3)(ii)(C)(6).

⁷⁰ Treas. Reg. § 1.482-3(d)(3)(ii)(C)(7).

⁷¹ Treas. Reg. § 1.482-5.

⁷² Treas. Reg. § 1.482-5(a).

⁷³ Joel B. Rosenberg et al., *Transfer Pricing Comparability: Concepts, Methods and Applications*, 5 CORP. BUS. TAX’N MONTHLY 4 (2003–2004).

comparability necessary for a reliable result in this method is for the most part less than the level required for the cost plus or resale price methods.⁷⁴

Practitioners calculate the operating profits for comparable firms to determine what financial performance the tested party should achieve if operating at arm's length with other controlled entities.⁷⁵ Two of the three profit level indicators outlined in the CPM regulations are based on operating profit (as mentioned previously), such as return on capital employed and return on sales or costs.⁷⁶ The CPM establishes the arm's length value of a controlled transaction by evaluating the profitability of uncontrolled entities engaging in similar activities under comparable circumstances.⁷⁷

Additionally, CPM emphasizes "operating profit"⁷⁸ centers on income categories such as: interest, dividends, profits from unrelated activities, and extraordinary gains and losses that are unrelated to the ongoing operations of the tested party.⁷⁹ In starting the CPM, the tested party plays a crucial role.⁸⁰ The tested party is the entity involved in the controlled transaction whose operating profit can be verified.⁸¹ This company typically offers the most reliable data and necessitates the fewest adjustments, making it a key focus for analysis.⁸²

The penultimate transfer pricing documenting method is Profit Split.⁸³ This method applies to both tangible and intangible property. It is also the method in which the most variation exists, amongst countries, in the way it documents its transfer pricing activity.⁸⁴ According to the OECD, three factors are important when a company is considering this method: (1) where a company makes its contributions, (2) the degree of integration of business operations, and (3) the assumption of economic risks upon each party in the transaction.⁸⁵ Tax

⁷⁴ *Id.* at 9.

⁷⁵ Treas. Reg. § 1.482-1(c)(2).

⁷⁶ Treas. Reg. § 1.482-5(b)(1).

⁷⁷ Treas. Reg. § 1.482-5(d)(4).

⁷⁸ Treas. Reg. § 1.482-5(b)(1).

⁷⁹ Treas. Reg. § 1.482-5(d)(4).

⁸⁰ *Id.*

⁸¹ Treas. Reg. § 1.482-5(b)(2)

⁸² *Id.*

⁸³ Treas. Reg. § 1.482-4(a)(3).

⁸⁴ FEINSCHREIBER, *supra* note 33

⁸⁵ OECD's *Final Guidance on the Application of the Profit Split Method - Record Details - EBSCO Discovery Service*,

authorities in both developing and developed countries favor this method because of common practices in profit-shifting strategies. For instance, whereas local group members receive only a minimal routine return, the remaining profits are allocated to entities in countries with low or no tax rates.⁸⁶ As a result, tax authorities in countries facing revenue losses are likely to promote the profit-split method, leveraging the OECD's final guidance to position it as the preferred approach in various situations.⁸⁷

The final method is the Unspecified Method.⁸⁸ This is one of four methods for regulating intangible property.⁸⁹ Recall, the comparable uncontrolled transaction method, the comparable profits method, and the profit split method. MNCs may elect the "unspecified transfer pricing method," if certain criteria are met.⁹⁰ This unspecified method for intangibles is similar to rules for unspecified methods for tangible property.⁹¹ An unspecified method for assessing intangibles can be used when determining if the price charged in a controlled transaction aligns with the arm's length standard.⁹² The same general principles and guidelines that govern tangible property transfers apply here. Consequently, the arm's length standard and the best method rule are relevant. Therefore, an unspecified method is only acceptable if it is identified as the best method for the situation.⁹³

A taxpayer has the option to employ an unspecified transfer pricing method instead of a specified one. If choosing this route, the taxpayer must adhere to specific criteria for selecting the method.⁹⁴ Two key

<https://research.ebsco.com/c/z63j24/search/details/vctoiijxcn?q=profit%20split%20method> (last visited Oct. 28, 2024).

⁸⁶ *Google U.S. Wins \$7 Million Tax Dispute Against Indian Officials* | *Tax Notes*, <https://www.taxnotes.com/featured-news/google-us-wins-7-million-tax-dispute-against-indian-officials/2023/02/27/7g008> (last visited Oct. 24, 2024)

⁸⁷ Jeffery M. Kadet et al., *Profit Split Method: Time for Countries to Apply a Standardized Approach*, No. 3235487 (Jul. 2018).

⁸⁸ Treas. Reg. § 1.482-3(e)

⁸⁹ Treas. Reg. § 1.6662-6(d)(3)(i)(B).

⁹⁰ Treas. Reg. § 1.482-4(d)(1).

⁹¹ FEINSCHREIBER, *supra* note 24 at 111.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ Treas. Reg. § 1.6662-6(d)(3)(ii)

types of documentation are necessary for those using unspecified methods: the principal document and background information.⁹⁵

The documentation rules are closely linked to the reporting obligations for foreign-owned U.S. corporations established in 1991.⁹⁶ Under the transfer pricing penalty regulations, taxpayers can avoid a net section 482 adjustment from being counted in penalty calculations by meeting both the specified method requirements and the necessary documentation standards.⁹⁷ This discussion focuses specifically on the documentation aspect, often referred to by practitioners as the "contemporaneous documentation" rules. The transfer pricing penalty regulations require taxpayers to adhere to strict timing rules, also known as "contemporaneous documentation" rules.⁹⁸ These regulations leave little room for compliance after the transactions occur. Taxpayers must submit the necessary documentation to the IRS within 30 days of a request.⁹⁹ Additionally, the documentation must be prepared and available when the tax return is filed, which further emphasizes the importance of timely documentation.

2. *How Critics of the Arm's Length Standard Have Responded to Transfer Pricing Methods*

However, critics of the ALS have pointed out that it is based on erroneous economic assumptions, and administratively fails as a corporate tax base allocation mechanism.¹⁰⁰ Some scholars have advocated for a change in rigidity of application to overcome the shortfalls of ALS.¹⁰¹ Still, it remains a component of transfer pricing analyses as

⁹⁵ Robert Feinschreiber & Margaret Kent, *Selecting Transfer Pricing Services Methods*, 9 CORP. BUS. TAX'N MONTHLY 21 (2007–2008).

⁹⁶ FEINSCHREIBER, *supra* note 24 at 285.

⁹⁷ *Id.*

⁹⁸ Treas. Reg. § 1.6662-6(d)(2)(iii)(A).

⁹⁹ *Id.*

¹⁰⁰ Glen Rectenwald, *A PROPOSED FRAMEWORK FOR RESOLVING THE TRANSFER PRICING PROBLEM: ALLOCATING THE TAX BASE OF MULTI-NATIONAL ENTITIES BASED ON REAL ECONOMIC INDICATORS OF BENEFIT AND BURDEN*. - EBSCO, 22 DUKE J. OF COMP. & INT'L LAW 425 (Spring 2012).

¹⁰¹ Ilan Benshalom, *Rethinking the Source of the Arm's-Length Transfer Pricing Problem*, 32 VIRGINIA TAX REVIEW 425 (May 2013).

it relates to section 482¹⁰² and the different approaches to determining taxable income in controlled intra-firm transactions.

The main provision of the IRC associated with transfer pricing is § 6662.¹⁰³ In situations where MNCs do not comply with standards and regulations set by tax authorities, § 6662 provides a penalty regime.¹⁰⁴ Under § 6662, penalties related to accuracy may be applied for underreporting taxes. These penalties can be either 20% or 40% of the underpaid amount, depending on the nature of the violation.¹⁰⁵

3. *The Scope of the Situation as a Legal and Policy Matter*

Tax evasion and corrupted uses of existing provisions threaten fair and consistent taxation across jurisdictions.¹⁰⁶ In comparison to jurisdictions abroad, the United States has more rules and regulations for determining transfer pricing, its documentation, and the respective penalties for the failure to abide by these rules.¹⁰⁷ Disputes in transfer pricing documentation commonly involve the underpayment of taxes based on transfer pricing calculations.¹⁰⁸ MNCs' use of advantageous tax jurisdictions lead to problems with calculation methods. In the U.S., it is the taxpayer who selects the valuation method that will yield the best approximation of price according to the arm's length principle.¹⁰⁹

Manipulation of transfer pricing creates many problems, but this note will focus on two, which involve (1) harmful competition at a global level, and (2) an unequal playing field with respect to the

¹⁰² *Supra* note 13.

¹⁰³ I. R. C. § 6662.

¹⁰⁴ Mark J Horowitz et al., *The Resurgence of Transfer Pricing Penalties*, 182 Tax Notes Federal 311 (Jan. 2024).

¹⁰⁵ Ray A Knight & Lee G Knight, *Taxpayers' Reliance on Professional Tax Advice: Examining the Penalties under IRC Section 6662 - EBSCO*, 83 The CPA Journal 36 (Feb. 2013).

¹⁰⁶ Messaoud Mehafdi, *The Ethics of International Transfer Pricing*, 28 J. OF BUSINESS ETHICS 365 (Dec. 2000).

¹⁰⁷ Rasoul H. Tondkar et al., *Transfer Pricing Practices and Regulatory Actions in the U.S. and U.K.: A Cross-Country Comparison and Analysis*, 18 ADVANCES IN INT'L ACCOUNTING 201 (Jan. 2005).

¹⁰⁸ *Id.* at 217.

¹⁰⁹ *Id.* 206.

advantage of MNCs and their advantage over non-multinational corporations who lack this tax strategy.¹¹⁰

Another point in the legal landscape of MNCs and transfer pricing is the importance of documentation. In recent years, the IRS and other tax authorities have created a new enforcement environment where MNCs risk penalties even when they provide documentation to the IRS if the IRS deems their documentation unsatisfactory.¹¹¹ As mentioned previously, increasing enforcement of adequate documentation is coupled with imposing penalties like §6662 in this new enforcement environment.¹¹²

B. How Tax Courts Have Treated the Issue of Inadequate Transfer Pricing Documentation

The following discussion presents the most recent treatment of transfer pricing civil suits in the tax courts of both the United States and Canada. These cases are recent and depict the resurgence of penalties for inadequate documentation. In previous decades, civil suits involving transfer pricing violations concerned, for the most part, the underpayment of taxes, as well as tensions between regulatory agencies and taxpayers.¹¹³ However, as of 2020, regulatory agencies are aggressively asserting penalties, prompting taxpayers to adjust their approaches to documenting their transfer pricing activity in response to this heightened enforcement.¹¹⁴ These cases emphasize the importance of intense diligence with respect to dealings between a parent company's and its affiliates—both foreign and domestic.

1. Transfer Pricing Cases in the United States

*Coca-Cola Co. v. Commissioner*¹¹⁵

¹¹⁰ Eduardo Baistrocchi & Ian Roxan, *Resolving Transfer Pricing Disputes: A Global Analysis* (Cambridge University Press Dec. 2012).

¹¹¹ Steven C. Wrapp & Chris Lee, *Increased U.S. Transfer-Pricing Enforcement: What's at Stake?*, 55 *The Tax Adviser* (Feb. 2024).

¹¹² Steven C. Wrapp et al., *RESOLVING TRANSFER PRICING DISPUTES*, 1 *Corporate Business Taxation Monthly* 13 (Aug. 2000).

¹¹³ Tondkar et al., *supra* note 107.

¹¹⁴ Steven C. Wrapp & Chris Lee, *Increased U.S. Transfer-Pricing Enforcement: What's at Stake? - EBSCO*, 55 *THE TAX ADVISER* (Feb. 2024).

¹¹⁵ *Coca-Cola Co. & Subsidiaries v. Comm'r of Internal Revenue*, No. Docket No. 31183-15, 2023 WL 7410872 (Nov. 8, 2023).

In this case, the corporate taxpayer, Coca-Cola Co. (Coca-Cola) based in Atlanta, Georgia, sued in 2020 seeking a redetermination of the IRS's reallocation of income that increased the company's taxable income in its tax returns from 2007 to 2009.¹¹⁶ The increase in Coca-Cola's taxable income totaled about \$9 billion, which resulted in tax deficiencies of more than \$3.3 billion.¹¹⁷ Coca-Cola's foreign affiliates were the manufacturers of the concentrate (the ingredients) of the company's soda and the bottlers of the product.¹¹⁸ The reallocation of income that resulted in transfer pricing adjustments involved section 482, whereby the IRS attributed income from the foreign affiliates to the company's tax bill.¹¹⁹ The IRS's main claim was that Coca-Cola's foreign subsidiaries did not pay an arm's length price for the use of its intangible property, which include trademarks, brand names, as well as formulas.¹²⁰

The income-generating activity that was called into question in this case were the transactions between Coca-Cola, its manufacturers, and its bottlers. Coca-Cola gave the foreign affiliates licenses to sell the concentrate.¹²¹ These transactions raised "transfer-pricing" red flags because Coca-Cola had control over its subsidiaries.¹²² Ultimately, the prices set in these intercompany transactions influenced how much the company paid in taxes.¹²³

Coca-Cola used the profit split method transfer pricing method, also known as the "10-50-50" method, which entails the calculation of royalty obligations.¹²⁴ 10-50-50 is broken down into the concentrate manufacturer's share of profits set equal to 10 percent of gross sales "plus 50 percent of the residual profit," leaving Coca-Cola with the "remaining 50 percent of the residual profit."¹²⁵ The IRS

¹¹⁶ *Id.* at 1

¹¹⁷ *Id.*

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ *Id.* at 3.

¹²¹ *Id.*

¹²² John D. Keyser & Erica L. Neuman, *A Different Kind of Cola War: Coca-Cola versus the IRS*, 38 ISSUES IN ACCOUNTING EDUCATION 140 (American Accounting Association 20230801).

¹²³ *Id.*

¹²⁴ *Supra* note 116.

¹²⁵ Keyser & Neuman, *supra* note 121, 140-141

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audited Coca-Cola's tax returns from 2007-2009 because the 10-50-50 method was not adequate under the arm's length principle.¹²⁶

Since the 10-50-50 method was inappropriate, the IRS retained Dr. Scott Newlson, an economist who served as the main contributor in developing code section 482, to determine the transfer pricing method that was best suited for Coca-Cola and its foreign subsidiaries.¹²⁷ Dr. Newlson determined the CPM as the appropriate method. This method compares profit allocation of uncontrolled taxpayers in similarly situated positions and transactions as the MNC.¹²⁸

The tax court ultimately sustained that the IRS's reallocation of income and held that Coca-Cola did not meet its burden of proof. It failed to provide evidence that would clarify issues, surrounding the portion of the transfer-pricing adjustment, related to its profit shifting. In the end, Coca-Cola's previous method did not consider the prices that could have been set under the arm's length principle when it engaged in intercompany transactions.

*Medtronic Inc. v. Commissioner*¹²⁹

The IRS appealed the Tax Court's decision which favored Medtronic, a creator of devices.¹³⁰ Medtronic licenses its intangible products to its foreign and domestic subsidiaries, which manufacture its products. The IRS claimed Medtronic's intercompany transactions were suspect and failed to reflect arm's length transactions. In determining which method was the best for valuing the intercompany transactions manifesting in the licensing of intangible property, the court ultimately disagreed with Medtronic's current method: the comparable uncontrolled transaction (CUT), instead preferring the unspecified model.¹³¹ The court rejected the previous CUT model because "it did not meet the 'functions,' 'economic conditions,' and 'property or services' general-comparability factors." The court asserted that the unspecified method was better at accounting for "...the imperfections of the CUT method, such as 'know-how,' having only one comparable, differences in profit potential, and imperfections of the CPM, such as

¹²⁶ Keyser & Neuman, *supra* note 121, 142.

¹²⁷ *Id.* at 143.

¹²⁸ Treas. Reg. § 1.482-5(1)(a)

¹²⁹ Medtronic, Inc. & Consolidated Subsidiaries, Nos. 23-3063, 23-3281, 2024 WL 733901, at *1 (8th Cir. Feb. 16, 2024).

¹³⁰ *Id.* at *16.

¹³¹ *Id.* at *35.

the inadequacy of the comparables and an unrealistic profit allocation.”¹³²

2. *Transfer Pricing Cases in Canada*

Before discussing Canadian transfer pricing cases, it is important to note a few things. First, the Canadian transfer pricing code is section 247 of the Income Tax Act.¹³³ Canadian transfer pricing comports with the arm's length principle. In addition to section 247, Canada also invokes the arm's length principle in the OECD's guidelines for MNCs engaging in transfer pricing.¹³⁴

What typically happens in Canadian transfer pricing audits is similar to the United States' procedure with respect to such cases. For instance, transfer pricing cases in Canada start with the invocation of section 247(4) by the Canadian Revenue Agency (CRA), which requests documentation—information requirements are outlined in subparagraphs 247(4)(a)(i) through (vi).¹³⁵ This subparagraph is very similar to the OECD guidelines, and it contains “five categories of comparability” for the proper use of the arm's length standard. Interestingly, Canadian courts employ the OECD guidelines in addition to their own in its assessments of arm's length and non-arm's length factors.

The five categories in the OECD guidelines are: (1) the characteristics of property or services, (2) the functional analysis, (3) the contractual terms, (4) the economic circumstances, and (5) the business strategies.¹³⁶

The six categories in subparagraphs 247(4)(a)(i) through (vi) are: (i) the property or services to which the transaction relates,¹³⁷ (ii) the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into

¹³² *Id.* at *37.

¹³³ R.S.C., 1985, c. 1 (5th Supp.)

¹³⁴ *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, OECD, https://www.oecd.org/en/publications/2022/01/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2022_57104b3a.html (last visited Sep. 25, 2024).

¹³⁵ Theresa Zinn et al., *Increasing Importance of Transfer Pricing Regulations: A Worldwide Overview*, *The*, 42 *INTERTAX* 377 (2014).

¹³⁶ *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, *supra* note 134.

¹³⁷ R.S.C. 1985, c 1 (5th supp), s 247(4)(a)(i).

between the participants in the transaction,¹³⁸ (iii) the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into,¹³⁹ (iv) the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction,¹⁴⁰ (v) the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction,¹⁴¹ and (vi) the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.¹⁴²

*Dow Chemical Canada ULC v. Canada*¹⁴³

In 2024, there was a dispute between the CRA and Dow Chemical Canada ULC (Dow), a corporation headquartered in Calgary, Alberta that specializes in supplying chemicals, plastics, and sealants. The relevant tax years in this case were 2006-2007. Dow engaged in a “non-arm’s length revolving loan agreement”¹⁴⁴ with a related company in Switzerland as its lender. Dow argued its taxable income should have been reduced “to reflect an amount of interest that would have been paid had the parties been at arm’s length.”¹⁴⁵ The case aimed to resolve the issue of which court—the federal court or the tax court—should handle the suit. But more relevant to the transfer pricing issue was whether the tax court had the authority to review the Minister’s discretionary refusal of granting a downward transfer pricing adjustment under section 247(10). The court held that the “[t]ax Court, as a specialized court, is well placed to rule on whether the discretion

¹³⁸ R.S.C. 1985, c 1 (5th supp), s 247(4)(a)(ii).

¹³⁹ R.S.C. 1985, c 1 (5th supp), s 247(4)(a)(iii).

¹⁴⁰ *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 247(4)(a)(iv) (Can.).

¹⁴¹ *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 247(4)(a)(v)(Can.).

¹⁴² *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 247(4)(a)(vi)(Can.).

¹⁴³ *Dow Chemical Canada ULC v. Canada*, [2024] 1 S.C.R. 23 (Can.).

¹⁴⁴ “Non-arm’s length loan agreements” are loan agreements between related corporations that are subject to scrutiny, by the Canadian Revenue Agency, because they raise tax evasion concerns. See Canada Revenue Agency, service description, *Definitions*, <https://www.canada.ca/en/revenue-agency/services/tax/businesses/definitions-letter-a-business.html> [<https://perma.cc/HV4C-DWN4>] (last visited Mar. 14, 2025).

¹⁴⁵ *Dow Chemical*, [2024] 1 S.C.R. para. 2.

under § 247(10) was properly exercised.”¹⁴⁶ The Minister had discretion to refuse the downward transfer pricing adjustment.

*Bank of Nova Scotia v. Canada*¹⁴⁷

The *Bank of Nova Scotia v. Her Majesty the Queen* case involved the CRA’s transfer pricing audit on one of the foreign subsidiaries of the Bank of Nova Scotia (BNS).¹⁴⁸ The relevant tax years spanned consecutively from 2006 to 2014.¹⁴⁹ The CRA reassessed BNS’s 2006 taxation year and increased its taxable income to \$54 million. BNS tried to offset this adjustment by requesting a carryback of \$54 million in non-capital losses from the 2008 taxation year.¹⁵⁰ While the carryback ended up nullifying the increased tax liability, \$7.9 million in arrears, spanning from 2006 to 2014, were assessed by the CRA. The case centered on whether the Federal Court of Appeal may hear an appeal on October 30 from the Bank of Nova Scotia regarding a Tax Court decision that rejected the bank’s preferred method for calculating interest in a transfer pricing settlement.¹⁵¹ In the end, the taxpayer lost.¹⁵² The CRA’s position, that arrears interest builds as tax liability increases from date of the original maturity date until the bank formally requests the loss carryback, was upheld.¹⁵³

III. RECENT REVIVAL OF §6662 ENFORCEMENT

The IRS did not apply § 6662 as much as it did in the past. As early as 1990 did the enforcement of penalties arrive on the tax law scene.¹⁵⁴ In 2012, the service created the Transfer Pricing Practice, a group consisting of transfer pricing experts in charge of developing and coordinating transfer pricing strategy.¹⁵⁵ Fast forward to 2018, the

¹⁴⁶ *Id.*

¹⁴⁷ *Bank of Nova Scotia v. Canada*, [2024] F.C.A. 192 (Can.).

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.* at para. 20.

¹⁵³ *Bank of Nova Scotia*, [2024] F.C.A (Can.).

¹⁵⁴ Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11312, 104 Stat. 1388, 1388-470 (1990).

¹⁵⁵ Steven C. Wrappe & Chris Lee, *Increased U.S. Transfer-Pricing Enforcement: What’s at Stake?*, THE TAX ADVISER (Feb. 1, 2024), <https://www.thetaxadviser.com/issues/2024/feb/increased-us-transfer-pricing->

momentum of penalty-enforcement on transfer pricing had built significantly. This was evinced by the directive the IRS imposed on the Large Business & International Division to devise appropriate applications of penalties under § 6662(e).¹⁵⁶ As discussed in previous sections, the IRS has seen recent success in its pursuit of adjustments.

IV. HOW CAN MNCs ALTER AND EVALUATE THEIR CURRENT DOCUMENTATION PRACTICES?

Consistent with the discussion in section III, MNCs ought to evaluate their documentation methods considering recent aggressive enforcement of penalties and major successes in litigation by the IRS. Previously accepted methods for documenting intercompany transactions are no longer guaranteed to be an acceptable form, as *Coca-Cola* demonstrated (i.e., the change from 10-50-50 to CPM).¹⁵⁷ As compared to the Canadian system of auditing corporations for transfer pricing violations, the main difference is that they incorporate the OECD's guidelines in addition to their own rules, outlined in their tax code. Still, there must be more to the transfer pricing picture. In looking at the United States' recent success in major cases, its application of the IRC and treasury regulations appear to work well. A deeper dive into comparable tax systems might reveal whether the IRS is justified in its recent approach, or if it is truly in disarray. To answer this, the following section contains a brief comparison between similar tax systems to the United States, including Great Britain, and finally, Australia.

enforcement-whats-at-stake.html [<https://perma.cc/GZ7J-XAZ4>] (last visited Mar. 13, 2025)

¹⁵⁶ *Transfer Pricing Documentation Best Practices Frequently Asked Questions (FAQs)*, INTERNAL REVENUE SERVICE, <https://www.irs.gov/businesses/international-businesses/transfer-pricing-documentation-best-practices-frequently-asked-questions-faqs> [<https://perma.cc/8FPC-7QUS>] (last visited Sept. 25, 2024).

¹⁵⁷ *Coca-Cola Co. v. Comm'r*, No. 31183-15, 2023 WL 7410872, at *2 (T.C. Nov. 8, 2023)

*A. Comparable Tax Systems: The United Kingdom and
Australia*

1. The United Kingdom

The update to the United Kingdom's transfer pricing rules was primarily driven by external factors, including the stricter transfer pricing regulations in the U.S., and recent proposals from the European Union and OECD addressing international tax avoidance.¹⁵⁸

Although the U.K. has had transfer pricing rules for nearly 50 years, the old framework operated under a quasi-voluntary system of arm's length pricing, which primarily affected larger multinational companies.¹⁵⁹ These rules were rarely enforced, and there is little case law on transfer pricing in the U.K. This relatively relaxed approach is perhaps reflected in the fact that the most notable case of U.K. transfer pricing abuse came from a Monopolies Commission investigation into the pricing of the tranquilizers Valium and Librium, rather than a tax audit by the Inland Revenue.¹⁶⁰ Furthermore, the arm's length standard was hardly defined in the relevant sections of the U.K. tax code— sections 770¹⁶¹ and the antecedent code section 485.¹⁶²

Key changes under the new transfer pricing rules include: (1) the automatic application of transfer pricing rules to all companies under the corporation tax self-assessment system, (2) explicit alignment of the rules with the OECD Model Tax Treaty, Article 9, and the OECD's transfer pricing guidelines, (3) a broader scope for the transfer pricing rules compared to the previous system, (4) the inclusion of 40% joint ventures within the rules, (5) The addition of thin capitalization provisions, (6) the introduction of procedures for Advance Pricing Agreements (APAs), and finally (7) the imposition of penalties for non-compliance.¹⁶³

¹⁵⁸ Daniel Hoi Ki Ho, *Multinational Transfer Pricing: Evidence in the United Kingdom*, 34 INT'L TAX J. 43 (2008).

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Companies Act 2006*, c. 46, § 770 (UK), <https://www.legislation.gov.uk/ukpga/2006/46/section/770> [<https://perma.cc/JFG8-DRVVR>] (last visited Mar. 14, 2025).

¹⁶² Tondkar et al., *supra* note 107, at 210.

¹⁶³ Hoi Ki Ho, *supra* note 158.

Also, in 2023, the U.K. released new requirements for transfer pricing records.¹⁶⁴ Starting on April 1, 2023, the regulations took effect. They follow general transfer pricing rules and enforce stricter reporting requirements on resident U.K. MNCs. The legislation also imposes a Country-by-Country Reporting threshold within a tax period.¹⁶⁵ The Country-by-Country Reporting test has two conditions: (1) at least two enterprises are resident U.K. enterprises for tax purposes (when jurisdictions are different), and (2) consolidated group revenues exceed €750 million, evidenced in financial statements, or in the records they use to compose those statements.¹⁶⁶

Recall that transfer pricing refers to the pricing of transactions between different parts of a multinational corporation (MNC), such as the exchange of goods, services, intellectual property, or capital.¹⁶⁷ These internal transactions impact the pre-tax profits of each entity involved and the amount of corporate tax each company must pay in their respective countries.¹⁶⁸ For example, if a U.K.-based pharmaceutical company buys raw materials from its Chinese subsidiary, the price the U.K. parent pays for those materials (the transfer price) determines the profit earned by the Chinese subsidiary and the taxes it owes in China, as well as the profit and tax obligations of the U.K. parent company.¹⁶⁹

Recall the intent behind transfer pricing rules—to assign profits and losses in a fair manner between related corporations and their foreign subsidiaries (parent and affiliates) to ensure that prices are

¹⁶⁴ Ernst & Young Global Ltd., *UK Publishes Requirements for Transfer Pricing Records*, EY, (Jul. 27, 2023) https://www.ey.com/en_gl/technical/tax-alerts/uk-publishes-requirements-for-transfer-pricing-records [<https://perma.cc/8NJ6-6W8Q>] (last visited Mar. 14, 2025).

¹⁶⁵ *The Transfer Pricing Records Regulations 2023, No. 818*, LEGISLATION.GOV.UK, <https://www.legislation.gov.uk/uksi/2023/818/made> [<https://perma.cc/7T38-NPVG>] (last visited Mar. 14, 2025).

¹⁶⁶ *The Taxes (Base Erosion and Profit Shifting) (Country-by-Country Reporting) (Amendment) Regulations 2017 No. 497*, LEGISLATION.GOV.UK, <https://www.legislation.gov.uk/uksi/2017/497/regulation/4/made> [<https://perma.cc/E9EK-GDU6>] (last visited Mar. 14, 2025).

¹⁶⁷ LI LIU, TIM SCHMIDT-EISENLOHR & DONGXIAN GUO, INTERNATIONAL TRANSFER PRICING AND TAX AVOIDANCE: EVIDENCE FROM LINKED TRADE-TAX STATISTICS IN THE UK, IN PROCEEDINGS. ANNUAL CONFERENCE ON TAXATION AND MINUTES OF THE ANNUAL MEETING OF THE NATIONAL TAX ASSOCIATION, VOL. 110 (2017).

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

reached at an arm's length, which aims to accurately reflect the costs and revenues of each party.¹⁷⁰

Starting with the similarities between the United States and the United Kingdom, both systems aim to abide by the arm's length principal when evaluating the appropriate transfer price in their respective intercompany transactions.¹⁷¹ Though both countries emphasize the importance of looking at comparable transactions at arm's length, they differ in how the prices are determined.¹⁷² The basic idea remains: to establish a transfer price grounded on what an independent, unrelated party would pay in a similar transaction.¹⁷³ This section further discusses the key aspects of each system.

Similar to the Canadian transfer pricing rules, the U.K. employs both its own rules and the OECD's guidelines as part of its 2010 Taxation Act.¹⁷⁴ The U.K. rules reflect a consistent theme in this study of transfer pricing rules— that of requiring its corporations to comport with adjustments to tax returns that reflect the arm's length principle.¹⁷⁵

Furthermore, in 2015, the U.K. introduced its Diverted Profits Tax (DPT). The DPT served as a preventative measure to deter MNCs from profit shifting and evading taxes.¹⁷⁶ This 2015 tax initiative borrowed transfer pricing principles but goes beyond them with respect to profit diversion and tax avoidance.

The two scenarios in which the DPT applies are (1) when transactions between related entities lack economic substance, which enables tax discrepancies, and (2) in situations where foreign companies outside the U.K. purposefully avoid establishing a taxable presence in the

¹⁷⁰ Bruce Clements & Alan Clements, *The Arm's-Length Standard in US and UK Transfer Pricing Rules*, 23 INT'L TAX R. 29 (Mar. 3, 2012).

¹⁷¹ *Id.*

¹⁷² *Id.*

¹⁷³ *Id.*

¹⁷⁴ Caroline Setliffe & Ben Shem-Tov, *Maintaining the Tax Base in the US and the UK: Transfer Pricing and Diverted Profits Tax*, INT'L. TAX REV. (Sep. 25, 2023), <https://research.ebsco.com/c/z63j24/search/details/7ojukonrkn?limiters=FT1%3AY%2CLB%3ATEIgKENhciogT1IgTWljKiBPUIBSZWYqIE9SIFJlcyogT1IgUmV2KiBPUIBTaG-wqIE9SIFNwZSogT1IgU3RhKiBPUIBTdG8qIE9SIFRlYyop&q=transfer%20pricing%20in%20uk> [https://perma.cc/B4SA-S3Z4] (last visited Nov. 24, 2024).

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

U.K. with the intent to evade tax liabilities in this jurisdiction.¹⁷⁷ Emphasis on deterring tax evasion and minimizing the U.K. tax obligations are the reasons for imposing a DPT rate that is 31% higher in sectors like banking and oil.¹⁷⁸ Also note that the DPT is not an additional corporate tax rate, rather it is its own tax that is not sufficient for qualifying for a credit under double tax treaties.¹⁷⁹ DPT is not unchallengeable. The Mutual Agreement Procedure exists for MNCs seeking relief in their contestations of the DPT.¹⁸⁰ The DPT also faced reform in 2023, along with the transfer pricing rules. The goal was to explore possibilities of integrating the DPT into the U.K. tax regime, in response to rising pressure from international jurisdictions implementing, enforcing, and amending new or existing transfer pricing rules, as well as the OECD's global erosion rules under its two-pillar solution.¹⁸¹

2. The European Union and Transfer Pricing

Turning briefly to the European Union's (EU) approach, this discussion aims to look at the EU's attempts to harmonize income taxes. However, these efforts have faced resistance from both older and newer member states.¹⁸² While there are proposals aiming for long-term changes, such as the "EU tax mix on the road to 2050," these have yet to gain widespread support.

One major shift, the impact of which has yet to be seen, is the BEFIT, which stands for Business in Europe: Framework for Income Taxation—a proposal for new corporate taxation structures in the

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ Setliffe & Shem-Tov, *supra* note 174.

¹⁸¹ *Id.*

¹⁸² Lipka Krzysztof, *EU and Transfer Pricing. Toward Petrification or Revolution?*, 29 J. PUB. ADMIN., FIN., & L. 311 (2023), <https://research.ebsco.com/c/z63j24/viewer/pdf/1647dsygvj> [<https://perma.cc/W63J-P85W>] (last visited Nov. 24, 2024).

EU.¹⁸³ The goal of this proposal is to create a stronger corporate tax system that could impact global transfer pricing significantly.¹⁸⁴

3. *Formulary Apportionment*

Currently, the arm's length principle remains as the foundation for any and all transfer pricing rules under the OECD. However, the OECD contains an alternative known as formulary apportionment (FA).¹⁸⁵ What is formulary apportionment? "Under FA, the profits of all consolidated entities of a business group are summed and then allocated according to a formula based on measurable proxies for inputs and/or outputs..." like payroll expenses, sales, and fixed assets.¹⁸⁶ The FA method is not totally foreign to the United States system. Actually, it was widely used by states in the 20th century. Preferences of the arm's length standard by governmental tax authorities are partially the reason why it is the most common and universal standard currently.¹⁸⁷ However, critics note that the arm's length standard is far from perfect with problems relating to its complexity, inefficiencies, inconsistencies, and even absurdities.¹⁸⁸ Were the EU to fully adopt the FA, it seems the benefit would be a simplification of rules.

Furthermore, the state of most EU countries regarding transfer pricing is relaxed compared to the United States. This is seen in the EU's Joint Transfer Pricing Forum, the focus of which was on construing the OECD guidelines but lacking alternative proposals to those guidelines.¹⁸⁹

It is argued that a world in which the FA totally replaced the arm's length principle would result in the risk of companies engaging in double-taxation to minimize, a common definition of the tax base,

¹⁸³ *Business in Europe: Framework for Income Taxation (BEFIT) - European Commission*, https://taxation-customs.ec.europa.eu/taxation/business-taxation/business-europe-framework-income-taxation-befit_en [<https://perma.cc/N6F6-E9DJ>] (last visited Mar. 14, 2025).

¹⁸⁴ *Id.*

¹⁸⁵ Reuven S. Avi-Yonah, *Between Formulary Apportionment and the OECD Guidelines: A Proposal for Reconciliation*, 2010 WORLD TAX J. 3 (2010).

¹⁸⁶ Sebastian Eichfelder et al., *Formula Apportionment: Factor Allocation and Tax Avoidance.*, 27 EUR. ACCT. R. 649 (Taylor & Francis Ltd. 2018).

¹⁸⁷ Avi-Yonah, *supra* note 185.

¹⁸⁸ *Id.* at 5-8.

¹⁸⁹ Krzysztof, *supra* note 182

minimal renegotiation of current tax treaties, lastly, “a balanced formula is less likely to produce consistent losers.”¹⁹⁰

4. *Australia’s Response to Ongoing Transfer Pricing Litigation and Anti-Tax Avoidance Proposals*

Moving on to the Australian system, litigation and intense anti-tax evasion measures are meeting Australian corporations with increased uncertainty with respect to transfer pricing.¹⁹¹ As a result, the adoption of more aggressive measures and heightened scrutiny of related-party transactions, describe the current approaches by the Australian Tax Office to the transfer pricing problems.¹⁹² As with the jurisdictions discussed in prior sections, the current transfer pricing environment in Australia necessitates reassessment by companies toward their transfer pricing strategies so that they are compliant and vigilant of potential risks and penalties.¹⁹³

Singapore Telecom Australia Investment Pty. Ltd. v. Commissioner of Taxation (SingTel)

This recent case portrays Australia’s emphasis on the arm’s length standard.¹⁹⁴ The federal court of Australia ultimately ruled against SingTel’s claim for an interest deduction based on intercompany interest rates that were not at arms length.¹⁹⁵ This highlighted how reporting methods played a major role in the court’s ruling.¹⁹⁶ While the reporting method exhibited by expert witnesses in this case assisted in promoting transparency—about the debt-pricing and interest deductions relevant to this case—it mainly offered the court a better sense

¹⁹⁰ Avi-Yonah, *supra* note 185, at 11-17

¹⁹¹ Amy Liu, *Australian Businesses Face Growing Transfer Pricing Uncertainty*, BLOOMBERG TAX (Mar. 4, 2024), <https://news.bloombergtax.com/tax-insights-and-commentary/australian-businesses-face-growing-transfer-pricing-uncertainty> [<https://perma.cc/T6Z6-7QG2>] (last visited Feb. 10, 2025).

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Singapore Telecom Australia Invs Pty Ltd v. Comm’r of Taxation*, [2021] F.C.A. 1597 (Austl.), <https://www.austlii.edu.au/cgi-bin/view-doc/au/cases/cth/FCA/2021/1597.html> [<https://perma.cc/6NH2-98SX>].

¹⁹⁵ *Singapore Telecom*, [2021] F.C.A. 1597.

¹⁹⁶ Kevin Yuen, *Australian Taxation Office Wins Singtel TP Dispute*, DLA PIPER (Feb. 7, 2022), <https://www.dlapiper.com/en/insights/publications/2022/02/australian-taxation-office-wins-singtel-tp-dispute> [<https://perma.cc/D4VB-SWG5>].

of the correct approach SingTel should have taken.¹⁹⁷ The correct approach would have been to incorporate an analysis of what independent parties would have agreed upon compared to what the intercompany dealing was inclined to do with respect to the debt-pricing and interest deductions.¹⁹⁸

Mylan Australia Holding Pty Ltd v. Commissioner of Taxation
(Mylan)

Another recent Australian case, *Mylan Australia Holding Pty Ltd v. Commissioner of Taxation (Mylan)*, serves to reinforce the importance of tax reporting methods.¹⁹⁹ While in this case the Australian Court focused more on anti-avoidance measures versus the transfer pricing measures, as in the *SingTel* case, it still suggests a strategic enforcement decision.²⁰⁰ The takeaway from the *Mylan* case is that companies need to carefully structure acquisitions and financing arrangements in accordance with tax laws with the goal of minimizing litigious actions with the tax authorities.²⁰¹

Additionally, an important aspect of Australia's transfer pricing approach is the country's "strict preference for the CUP method."²⁰² Recall, the CUP method (Comparable Uncontrolled Price method) compares prices of transactions between related parties to unrelated parties.²⁰³ The activities involved in the CUP method are also known as "controlled" and "uncontrolled" transactions.²⁰⁴ The goal of this method is to compare the controlled transactions to similar transactions of uncontrolled parties.²⁰⁵ In response to these basic transfer

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ *Mylan Austl Holding Pty Ltd v Comm'r Tax'n* [2023] FCA 672 (21 June 2023) (Austl.).

²⁰⁰ Liu, *supra* note 191

²⁰¹ *Id.*

²⁰² Zinn, Riedel & Spengel, *supra* note 135, at 359.

²⁰³ Zrinka Golemac & Iris Loncar, *Transfer Pricing Regulations in Selected European Countries*, 21 ANNALS DAAAM FOR 2010 & PROC. 21ST INT'L DAAAM SYMP. 0833, 0833 (2010).

²⁰⁴ Feinschreiber & Kent, *supra* note 95, at 21-23

²⁰⁵ *Id.* at 22-24.

pricing strategies, Australia has devised a three-phased reform to its transfer pricing regime.²⁰⁶

5. *Brief Overview of Australia's Three-Phased Reform:*

As mentioned previously, Australia began its transfer pricing regulation in the 1980s.²⁰⁷ The first phase of the reform was codified in Division 13 of Australia's Income Tax Assessment Act (ITAA) in 1982 but later repealed in 2013.²⁰⁸ The second phase sought to address perceived deficiencies in the first phase. Finally, the third and current phase ended previous rulings and replaced them with newer rules from the Tax Laws Amendment Act of 2013—these rules aimed to counteract tax avoidance and multinational profit shifting.²⁰⁹

Australia's First Phase of Reforms:

This first phase placed the responsibility on the taxpayer to assess their own tax liability.²¹⁰ Prior to the first phase, the Australian Tax Office (ATO) sought to enforce a level of self-assessment by imposing a number of tax rulings and it was up to the Commissioner of Taxation to oversee transfer pricing activities, audit, and make disputes.²¹¹ At this phase, companies placed little importance on arm's length principles and their reporting and documentation methods were also scant.²¹² Consequently, the ATO published penalties along with the tax rulings.²¹³ With respect to documentation methods, at this early stage, the ATO sought to provide companies with flexibility since reporting depends on the varying circumstances and facts of companies.²¹⁴

Relevant OECD provisions influenced Australia's transfer pricing rulings. For example, the first phase of reform included a four-step process to test the arm's length nature of controlled international

²⁰⁶ Nicole Wilson-Rogers & Dale Pinto, *Reconceptualising Australia's Transfer Pricing Rules: An Approach Based on Adopting Economic Presence as a Basis for Taxation*, 13 J. TAX RSCH. 406, 408 (2015).

²⁰⁷ Zinn, Riedel, & Spengel, *supra* note 135, at 355.

²⁰⁸ Wilson-Rogers & Pinto, *supra* note 206, at 409.

²⁰⁹ *Id.* at 409.

²¹⁰ David Grecian, *Australia's Approach to Transfer Pricing Documentation and Penalties*, 10 GEO. MASON L. REV. 915, 915 (2002).

²¹¹ *Id.* at 915.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.* at 917.

dealings.²¹⁵ The first step involved accurately characterizing controlled international transactions within the context of their business.²¹⁶ The point of this step was to provide not just compliance with transfer pricing rules, but also to give clear rationales for intercompany dealings. Acceptable documents included any contracts or agreements that would help in examining, assessing, and identifying industry conditions, business objectives, and basic decision-making of the companies involved in the controlled transaction.²¹⁷ The second step was more straightforward: a company simply had to pick a transfer pricing method and document it. The third step required the company to assess the arms length outcome and document it. To accomplish this, the company had to conduct “comparability analyses” and “functional analyses.”²¹⁸ The fourth step required companies to establish support processes, implement a review system to adjust for material changes, and document these procedures to ensure compliance and accuracy in transfer pricing.²¹⁹ This mainly involved monitoring international transactions, collecting relevant data associated with these transactions, and lastly establishing a method for review for the purposes of adjusting the comparability analyses in the event there are material changes.²²⁰

Penalties Under the First Phase of Reforms:

In the first phase of reforms, the ATO did not increase penalties for a company-taxpayer's failure to maintain contemporaneous documentation. However, keeping proper documentation served to lessen penalties for company-taxpayers. These conditions are outlined in TR 98/11²²¹ and the ATO's ruling on transfer pricing penalties, TR 98/16.²²² There are five levels of documentation standards in Australia:

²¹⁵ *Id.* at 918-19.

²¹⁶ Grecian, *supra* note 210, at 918.

²¹⁷ *Id.* at 918.

²¹⁸ *Id.* at 919.

²¹⁹ *Id.*

²²⁰ *Id.*

²²¹ See Australian Taxation Office, *Income Tax: Documentation and Practical Issues Associated with Setting and Reviewing Transfer Pricing in International Dealings* (TR 98/11, 24 June 1998).

²²² Australian Taxation Office, *Income Tax: International Transfer Pricing – Penalty Tax Guidelines* (TR 98/16, 4 November 1998).

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- Level 1: Low Quality
- Level 2: Low-Mid Quality
- Level 3: Medium Quality
- Level 4: Mid-High Quality
- Level 5: High Quality²²³

It used to be that taxpayers who maintained medium-high or high-quality documentation could generally expect a full waiver of transfer pricing penalties if the ATO conducted transfer pricing audits and made adjustments.²²⁴

Australia's Second Phase of Reforms:

The second phase enacted rules from the ITAA 1997 in September 2012 and their application began in 2004.²²⁵ Though apparently “controversial,” this phase sought to make up for deficiencies in the previous reform. For example, the previous Division 13 rules did not emphasize the Double Tax Agreement (DTA), which is another transfer pricing enforcement authority in Australia.²²⁶ The second phase also came about in response to *Commissioner of Taxation v. SNF (Australia) Pty Ltd.*, where uncertainty arose regarding whether Australia's DTAs could confer taxing powers, issues about the role of profit-based methods in reallocating transfer prices, and questions about the Commissioner's power to reconstruct or disregard transactions under other anti-avoidance rules, such as thin capitalization provisions.²²⁷

Additionally, within the second phase of reforms there was a sword versus shield debate regarding Australia's DTA's ability to confer taxing powers.²²⁸ The result of this reform was that Division 815-A allowed DTAs to work as a "sword" rather than a "shield," potentially exceeding their intended purpose.²²⁹ While DTAs are generally meant to allocate taxing rights to prevent double taxation, this provision arguably created new taxing powers. In *Undershaft (No 1) Ltd v FCT*, the Court clarified that a DTA does not grant a country the power to tax but merely allocates taxing rights between nations. Also,

²²³ Grecian, *supra* note 210, at 923.

²²⁴ *Id.* at 921.

²²⁵ Wilson-Rogers & Pinto, *supra* note 206, at 418.

²²⁶ *Id.* at 419.

²²⁷ *Id.* at 417-18.

²²⁸ *Id.* at 418.

²²⁹ Wilson-Rogers & Pinto, *supra* note 206, at 419; *see also Income Tax Assessment Act 1997* (Cth) sub-div 815-A (Austl.).

Subdivision 815-A granted the Commissioner an unlimited amendment period to make transfer pricing adjustments.²³⁰

Australia's Third Phase of Reforms:

The third transformation, which began around 2013, modernized Australia's transfer pricing framework to align with international standards.²³¹ Unlike section 815-A from phase 2, this new regime operates prospectively. This phase, more so than the previous phases, aims to ensure that the taxable amount reflects the economic contribution made by Australian operations. These provisions are designed to clarify that the Commissioner can reference the OECD guidelines and consider the overall arrangements of the taxpayer, rather than focusing solely on the specifics of individual transactions.²³² Unlike the previous two reform phases, the self-assessment obligation falls solely on the taxpayer.²³³ More recently, Australia's current phase of reform has enforced stricter documentation requirements, whereas the previous reforms did not have any. The third phase's documentation requirements are listed in 284-E of Schedule 1 to the TAA 1953.²³⁴

284-E of Schedule 1 to the TAA 1953 Documentation Requirements
Summary²³⁵

To comply with Subdivision 815-B or 815-C of the Income Tax Assessment Act 1997, an entity's records must:

- Be prepared before filing the income tax return for the relevant year.
- Be in English or easily convertible to English.
- Explain how the provisions apply (or do not apply) to the transaction.
- Justify consistency with OECD guidance as per Sections 815-135 or 815-235.

Additionally, the records must clearly show:

²³⁰ Wilson-Rogers & Pinto, *supra* note 206, at 419.

²³¹ *Id.* at 420.

²³² *Id.*

²³³ *Id.* at 424

²³⁴ *Id.* at 424; *see also Taxation Administration Act 1953*, s 284-255 (Austl.) (section 284-255 is within of sub-division 284-E containing documentation requirements).

²³⁵ *Taxation Administration Act*, s 284-255 (Austl.).

- Arm's length conditions relevant to the transaction.
- Methods and comparable data used to determine arm's length pricing.
- Impact of applying vs. not applying the Subdivision on the entity's tax position.
- For Subdivision 815-B: The actual conditions of the transaction.
- For Subdivision 815-C: The actual and arm's length profits, along with relevant business activities and circumstances.

6. *Worldwide View of Transfer Pricing Regulations*

Before concluding, the following presents a glimpse of transfer pricing world-wide. Since the 1980s, Australia and other jurisdictions have made strides in developing more transfer pricing regulations. However, seven countries in the world still do not have their own transfer pricing regulations.²³⁶ Those countries are: Austria, Ireland, Luxembourg, Malaysia, Philippines, Switzerland, and Thailand.²³⁷ While they lack regulations of their own, this does not mean they operate without any regulations. For the most part, these countries apply the OECD guidelines.²³⁸

V. CONCLUSION

The United States, Canada, the United Kingdom, and Australia have all made recent developments with respect to transfer pricing. All these systems predominantly abide by the arm's length standard when it comes to evaluating transactions between related parties. Profit shifting and tax avoidance are the main aspects each evasion prevention scheme attempts to tackle, while the enforcement of penalties, reporting, and documentation requirements serve as avenues to avoid audits. It seems the United States has taken the lead in its pursuit of catching suspicious activity within transfer pricing. Its system offers MNCs options of documentation methods according to the circumstances surrounding transactions, the goods and services exchanged, and the economies in which its foreign subsidiaries are located. Though the United States' approach to cracking down on tax evasion

²³⁶ Zinn, Riedel & Spengel, *supra* note 135, at 356.

²³⁷ *Id.*

²³⁸ *Id.* at 352, 356.

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via transfer pricing documentation is imperfect in many ways, it has seen recent success in cases with substantial adjustments. As of now, the United States seems justified in its approach.