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THE BEST OF BOTH METHODS: A PROPOSAL FOR A HYBRID INTERNATIONAL TRANSFER PRICING METHOD

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This paper examines alternatives to the current international transfer pricing method, the arm's length standard, that will better suit increasingly intangible-related industries and ward off tax avoidance tactics by multinational corporations. Among other issues, the arm's length standard fails to consider that multinational enterprises (MNE's) operate differently from third party corporations, does not properly account for nontraditional assets, such as intangibles, and leaves taxpayers and governments with uncertainty throughout the transfer pricing process. In identifying a more appropriate method, this paper considers the varying transfer pricing methods currently used by multinational corporations around the world and contemplates the advantages and disadvantages of each method. This paper proposes a hybrid approach to transfer pricing and advocates for the use of the arm's length principle solely for transactions in which comparable data exists; conversely, when measuring transactions for which there is no similar data and the arm's length principle is inadequate, the residual profit split method should be utilized. The recommended method

is examined through a case study involving the BMW Group, a large multinational corporation that routinely deals with transfer pricing related decisions. The proposed transfer pricing method capitalizes on the most valuable features of both the arm's length standard and the formulary apportionment approach to solve prevalent issues caused by the current method.

I. INTRODUCTION

The BMW Zentrum, a modern, white, and pristine building, is visible from the lanes of southbound Interstate 85 in Spartanburg County, South Carolina. Most interstate drivers speeding by at 65 miles per hour only take their eyes off the road long enough to notice the uniquely shaped visitors center; however, the unknowing passerby is also driving past a seven million square-foot campus capable of producing 1,500 BMW vehicles per day through the employment of 11,000 people.[1] Every single BMW X-line vehicle in the world has progressed through the plant's multiple body shops, paint shops, and assembly halls as the Spartanburg plant is the global producer of all BMW X models.[2] Any local resident will quickly inform you of the positive effect the BMW Group brought to the Upstate of South Carolina. In addition to creating 11,000 jobs on its own automobile manufacturing plant, BMW brought with it more than 40 major automotive part suppliers to the state of South Carolina. The German automotive corporation brought new life to a state that was feeling the effects of the waning textile industry, South Carolina's economic driver for countless years.[3] Today, practically

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[1] THE BMW GROUP, *BMW Manufacturing*, https://www.bmwgroup-plants.com/spartanburg/en/our-plant/site-infos.html (last visited Nov. 13, 2020).

[2] *Id*.

[3] David Wren, *Economic Driver: BMW's Impact on South Carolina's Manufacturing Growth, Psyche Has Been Immeasurable*, THE POST AND COURIER, (June 17, 2017), https://www.postandcourier.com/business/economic-driver-bmw-s-impact-on-south-carolina-s-manufacturing/article_29b50b10-51e4-11e7-b3dc-83f7d1a3d4c0.html (last visited Nov. 13, 2020).

every imaginable part of an automobile is produced in the Upstate of South Carolina.

As with any multinational corporation, there are many aspects to BMW that a passerby will not notice or even consider; these facets might encompass marketing schemes, research and development teams, and accounting departments. While such aspects are often overlooked, most likely even less thought is given to the transfer pricing methods employed by the multinational corporation. Bayerische Motoren Werke, better known as BMW, is headquartered in Munich, Germany, but has a presence all over the world.[4] With 30 production and assembly facilities in 14 countries and a sales network in at least 140 countries, the BMW Group deals with transfer pricing-related decisions on a daily basis.[5] Like BMW, the majority of the automotive manufacturers in the Upstate are members of multinational corporations; many of the Upstate locations are simply production plants or operational offices for a much larger company headquartered elsewhere. With so many ties to multinational corporations in its counties, the Upstate of South Carolina's growth could be affected by a change in an international taxation issue, such as transfer pricing.

Transfer pricing is the process of putting a price to a transaction between related parties, usually individual entities or subsidiaries of a large, multinational corporation.[6] While transfer pricing itself is not inherently illegal, these companies have found that it is possible to manipulate their tax liabilities by moving profits to lower tax jurisdictions, allowing them to avoid paying taxes on these profits in average or high tax regions. Countries view transfer pricing as a threat to their annual tax revenue and their fear is well-founded; shifting multinational corporations' income from one country to a lower-tax jurisdiction has been estimated to result in 10% of

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4 THE BMW GROUP, *The BMW Group – A Global Company*, https://www.bmwgroup.com/en/company/locations.html (last visited Nov. 13, 2020).

5 *Id.*

6 Alicia Tuovila, *Transfer Price*, INVESTOPEDIA (May. 29, 2020), https://www.investopedia.com/terms/t/transferprice.asp (last visited Nov. 13, 2020).

corporate revenue, or at least $125 billion, to be lost tax revenue for countries around the world.[7] Ideally, the international business world would allow for both multinational corporations' goals and the primary objective of transfer pricing rules to harmoniously thrive. Multinational corporations operate to maximize their after-tax profits, for the good of the company and shareholders.[8] The "central goal of transfer pricing rules is to 'allocate a reasonable amount of income from a particular transaction to the appropriate taxpayers and jurisdictions, having regard to their inputs into the income-earning process.'"[9] Because we live in a clearly imperfect world, it is not possible for these goals to coexist.

Regulations have been put into place to keep companies from taking advantage of the taxing jurisdictions; the principal standard that has been adopted to regulate the prices a corporation "charges" its related entities is the arm's length standard. While this standard has suited the international tax world for several years after its creation through U.S. tax law in 1935, it is becoming increasingly insufficient with changes in industries and entire economies.[10] Instead of successfully identifying a similar widget to compare to the corporation's own widget, corporations are left stranded, attempting to find similar technology akin to their new, top of the line technology for valuation purposes. The business world is no longer centered on the industrial factory economy; instead of tangible goods and observable services, many companies' focuses have shifted to complex nontraditional assets and services that are

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[7] Peter Jansky & Miroslav Palansky, *Estimating the Scale of Profit Shifting and Tax Revenue Losses Related to Foreign Direct Investment*, 26 INT'L TAX & PUB. FIN. 1048, 1049 (2019).

[8] J. Clifton Fleming, Jr. et al., *Formulary Apportionment in the U.S. International Income Tax System: Putting Lipstick on a Pig?*, 36 MICH. J. INT'L L. 1, 2–3 (2014).

[9] Charles F. Connolly, *The New Transfer Pricing and Penalty Regulations: Increased Compliance, Increased Burdens, and the Search for a Safe Harbor*, 16 U. PA. J. INT'L BUS. L. 339, 340 (quoting David R. Black, *Splitting Profits: Finding the Right Transfer-Pricing Methodology*, 41 CAN. TAX J. 140, 141 (1993)).

[10] 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, 97 (1995).

seemingly immeasurable. The arm's length method has lost its effectiveness as the sole international standard with the rise of incomparable assets. Changing times and developing industries require that the tax codes and agreements evolve; however, as the term "evolve" implies, the transition to an alternate transfer pricing system has grown into a marathon, not a brisk sprint.[11] The conversation of alternatives to the arm's length standard has been ongoing for several years.

It has been said that "international taxation is, to some extent, a zero-sum game" and this is evident in transfer pricing.[12] An alteration to the transfer pricing requirements might appease taxpaying MNE's, but leave taxing governments scrounging for revenue; likewise, modifications to the rules that increase reluctant MNE's tax liabilities will concurrently satisfy the governments' need for funds. All in all, it is impossible to please all involved parties in the world of taxation. Nevertheless, a new method of regulating transfer pricing that allows for a compromise of these contending objectives is possible. This paper will propose a change to the current transfer pricing standard that will allow for the concept of the arm's length standard to continue, but with modifications that consider the present and future types of goods and services. Readers of this paper are encouraged to consider the proposal and any alternative solutions that respond to the need for an accurate, fair, and equitable solution.

Consistency is a requirement for transfer pricing to be successful; without uniform application of the same method across the world, double taxation of multinational corporations will occur. Double taxation is simply "when the same income is taxed in two

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[11] Josh White, *OECD Presents "Unified Approach" to Profit Allocation*, INT'L TAX REV. (Oct. 9, 2019), https://www.internationaltaxreview.com/article/b1hhyplmx1dh75/oecd-presents-unified-approach-to-profit-allocation (last visited Nov. 13, 2020).

[12] Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1303 (1996).

different countries."[13] For example, if the United States has adopted the arm's length standard, but other countries insist on using a variation of formulary apportionment, a corporation operating in the United States and abroad will most likely face double taxation because of the differing transfer pricing methods. Double taxation may even remain a threat with mutual agreement across the globe; not only is consistent legislation and regulation needed, consistent application is required to avoid double taxation.[14] An alternative solution to the rising presence of intangible assets must be effective, but it must also be accepted and adopted around the world.

Before proposing a different way to regulate the transfer pricing process, this paper will lay a foundational basis in transfer pricing. Knowledge of the various transfer pricing methods is helpful in understanding the conversations that are currently taking place by international leaders, commentators, and students as they attempt to find the best, possible method. In Part II, this paper will discuss the current international method used in transfer pricing, the arm's length standard, and will lay out the advantages and disadvantages of this method. Next, the paper will cover the alternative formulary apportionment method, examining the positive and negative attributes it could bring to the international taxation system. There are also specific transfer pricing methods that require some discussion before launching into the main part of the paper; we will examine the comparable uncontrolled price ("CUP"), cost plus, resale price, profit-split, and comparable profits ("CPM") methods. It has been suggested that these methods are best viewed on a continuum between the arm's length principle and the formulary apportionment option, so the paper will lay out the distinctions as well as the similarities between the techniques.[15]

After laying the proper groundwork, in Part III the paper will introduce a better alternative to the current transfer pricing method. Using suggestions from compelling commentators, the paper will

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[13] Julia Kagan, *Double Taxation*, INVESTOPEDIA, (May. 26, 2020), https://www.investopedia.com/terms/d/double_taxation.asp (last visited Nov. 13, 2020).

[14] Harlow N. Higinbotham et al., *Effective Application of the Section 482 Transfer Pricing Regulations*, 42 TAX L. REV. 295, 302 (1987).

[15] Avi-Yonah, *supra* note 10, at 93.

propose that the use of the arm's length principle in combination with the residual profit split method will produce the best results in warding off tax avoidance. This portion of the paper will delve into the specifics of how combining the two, varying approaches will produce a "best of both worlds" solution. The paper will discuss the technicalities of the methods and explain how the current United States' transfer pricing method is an example worth imitating.

In Part IV, the paper will put the recommendation into action with a scenario involving BMW. With 30 production and assembly facilities in 14 countries and a sales network in at least 140 countries, the BMW Group gives us an ideal illustration as the company deals with transfer pricing-related decisions on a daily basis.[16] Hypothesizing the proposed method in action will allow readers to consider the advantages and disadvantages of this paper's suggested method. In the end, readers should realize that there are various transfer pricing method options and that some of them are incrementally superior to the current arm's length principle. Whether the proposed method is ultimately agreed upon, it is widely recognized that alterations should be made to the current arm's length principle.

II. BACKGROUND

A. ARM'S LENGTH PRINCIPLE

The arm's length principle is published in Article 9 of the OECD (Organisation for Economic Co-operation and Development) Model Tax Convention:

> [Where] conditions are made or imposed between the 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

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16 THE BMW GROUP, *supra* note 4.

> accrued, may be included in the profits of that enterprise and taxed accordingly.[17]

Arm's length treatment attempts to replicate transactions between unrelated companies in similar transactions.[18] A version of the arm's length principle has been adopted by all advanced economies in the world. In the United States, the principle has been codified in the § 482 regulations of the Internal Revenue Code:

> In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances.[19]

Section one of Germany's External Tax Relations Act (Außensteuergesetz) contains the country's version of the arm's length standard.[20] Even though Germany's arm's length standard is practically identical to the § 482 in the U.S. Code, since BMW is headquartered in Germany and subject to that country's regulations, the automotive corporation follows their version of the arm's length standard. Put into practice, consider the two following hypothetical scenarios. In our first transaction, Company A produces chassis components and sells these to Company B for the completion of

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17 OECD, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 35 (2017).

18 *Id.*

19 26 U.S.C. § 1.482-1(b).

20 Außensteuergesetz (AStG) [Foreign Taxation Law], Sept. 8, 1972, BUNDESGESETZBLATT I [BGBl. I] [FEDERAL GAZETTE I] at 1713, § 1, as amended, Dec. 22, 2014 BGBl I. at 2417.

Company B's automobiles; these two companies are not related, so this is considered an "uncontrolled transaction" and the terms of the transaction were conducted at "arm's length." In our second transaction, BMW's Dingolfing, Germany plant produces the chassis components and ships them to BMW's Spartanburg plant located in the United States for installation in an X-line vehicle. Both entities are owned by the BMW Group; therefore, they are related and this transaction is a "controlled transaction." To comply with transfer pricing regulations, this transaction's terms should be decided per the arm's length principle. If our second transaction involving BMW is accomplished with the same terms as the first hypothetical transaction, it was successfully conducted according to the arm's length principle.

While the international tax world is debating the diverse transfer pricing methods, there are some who staunchly defend the current, traditional arm's length standard. Those in favor of the arm's length standard advocate in favor of its flexibility and adaptability in each application.[21] While the arm's length principle must be applied on a case-by-case basis, defenders of the principle argue that this is a beneficial attribute; transactions differ, so the approach to transfer pricing should reflect that. A substitute for the arm's length principle can be found in formulary apportionment methods: the use of aggregate data from many transactions to allocate profits across countries based on select factors.[22] Some argue that the simplicity of formulary alternatives is deceivingly appealing; multi-billion dollar transactions from one country's jurisdiction to another should not be confined to an elementary calculation. Additionally, many prefer the arm's length principle because it does not differentiate between multinational corporations

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[21] Brian D. Lepard, *Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm's Length Standard as a Case Study*, 10 DUKE J. COMP. & INT'L L. 43, 56 (1999).

[22] TAX POL'Y CTR., *Tax Policy Center Briefing Book: A Citizens' Guide to the Fascinating (Though Often Complex) Element of the US Tax System* (2020), https://www.taxpolicycenter.org/briefing-book/how-would-formulary-apportionment-work.

and companies that are wholly operated within one country.[23] Advocates of the arm's length principle also tout the method's widespread acceptance around the world as a reason to maintain the status quo; they question the need for expensive and time-consuming debate on a method that is not necessarily broken in their eyes.[24] It is argued that a new concept will not be able to reach the consensus that the arm's length principle has enjoyed for 85 years now and that uniform agreement on a new method is impossible. Without agreement regarding each piece of the formula, countries will employ different methods with different results. In summary, many of the arguments for the arm's length standard stem from the "if it ain't broke, don't fix it" mentality.

However, critics of the arm's length standard argue that it is, indeed, broken. The considerable number of arguments against the use of the arm's length principle explains why many are exploring alternative transfer pricing options. First, the arm's length principle is applied on a case-by-case basis that diminishes governments' ability to enforce the principle and corporations' ability to follow the rules.[25] As both groups are increasingly faced with new transactions that are unlike ones seen before, it becomes difficult for them to accomplish their jobs. The contextual nature of the method also results in unnecessarily taking up time and money on both the government's and company's part.[26] Unless the corporation is dealing with familiar cases involving tangible goods and services with comparable transactions, compliance can be time-consuming for the corporation's accountants and tax attorneys. Professionals' time is taken up with the attempt to find similar transactions for their own company's transactions for which there may be no comparison. Effectively, corporations' resources are consumed through this system. The government is also burdened by the complications of

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[23] Nissar Chamroo, *"The Arm's Length Principle (ALP) is too resource intensive, and time consuming, to be of practical use to taxpayers and tax authorities,"* LINKEDIN (Jan. 10, 2018), https://www.linkedin.com/pulse/arms-length-principle-alp-too-resource-intensive-time-nissar-chamroo/.

[24] Lepard, *supra* note 21.

[25] Fleming et al., *supra* note 8, at 15.

[26] Avi-Yonah, *supra* note 10, at 150.

the arm's length principle. Enforcement of the principle demands the time of highly-experienced Internal Revenue Service personnel that could be spent on other matters.[27] Similarly, the Tax Court's docket is filled with transfer pricing cases that could be avoided with a different method.[28] The arm's length principle has been described as a Pyrrhic victory; while the principle does restrict multinational corporations' income-shifting to lower-tax jurisdictions, it comes with steep costs.[29] These costs include time and money burdens, litigious controversies, and regularly noncompliant corporations. While a method that decreases tax avoidance should be considered a victory, the international tax standard should not be accompanied by so many burdens.

Second, notwithstanding the cost and time that goes into arm's length transfer pricing, the IRS' estimation of tax revenue from corporations' transfer pricing transactions differs wildly from corporations' measurement of their tax expenses to be paid. This discrepancy leads to attempts at resolution, usually in the form of a Tax Court case or negotiations by countries in the competent authority process; however, the end results of these cases and conventions are routinely amounts that neither party to the issue suggested at the outset.[30] The multitude of "possible answers" to the question presented to the court has led many people to doubt the integrity of the principle.[31]

Third, the arm's length principle gives tax attorneys, accountants, and governments quite possibly what they all fear most: uncertainty.[32] These parties are unable to begin and end their

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[27] Reuven S. Avi-Yonah & Ilan Benshalom, *Formulary Apportionment: Myths and Prospects – Promoting Better International Policy and Utilizing the Misunderstood and Under-Theorized Formulary Alternative*, 3 WORLD TAX J. 371, 377 (2011).

[28] Avi-Yonah, *supra* note 10, at 150.

[29] Avi-Yonah & Benshalom, *supra* note 27.

[30] Avi-Yonah & Benshalom, *supra* note 27; Cym H. Lowell & Peter L. Briger, *Adequacy of International Dispute Resolution Mechanisms*, 10 GEO. MASON L. REV. 725 (2002).

[31] *Id*.

[32] Avi-Yonah, *supra* note 10, at 150.

work with confidence in their performance. Companies cannot be sure that the numbers they submit to the Internal Revenue Service will be confirmed; they must wait until they receive notice of a dispute or the window of time for that notice passes before feeling satisfied with their conclusion. The companies' investors are also left with a feeling of uncertainty when perusing the corporation's financial statements.[33] On the other side of the tax return, the government is unable to estimate their tax revenue for the year because of the ambiguous guidelines set out for companies.[34]

The fourth reason to be critical of the arm's length principle is that it opens the door for tax avoidance and abuse of the method. The US Treasury, GAO, OECD, and other such entities have all suggested that there is an absurd amount of tax revenue not being collected by governments' revenue services because of tax avoidance tactics.[35] Shifting multinational corporations' income from one country to a lower-tax jurisdiction has been estimated to result in 10% of corporate revenue, or at least $125 billion, to be lost tax revenue for countries around the world.[36] The OECD predicts that $240 billion is lost annually from multinational companies' tax avoidance.[37] The Tax Justice Network estimated an annual loss of $500 billion, or 20% of corporate tax revenues, by governments because of profit shifting.[38] The very concept of tax avoidance makes it an extremely difficult number to pin down, but these

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33 Avi-Yonah & Benshalom, *supra* note 27.

34 *Id*. at 377–78.

35 *Abusive Offshore Tax Avoidance Schemes – Talking Points*, IRS, https://www.irs.gov/businesses/small-businesses-self-employed/abusive-trust-tax-evasion-schemes-talking-points (last visited Nov. 13, 2020); *Offshore Tax Evasion: IRS Has Collected Billions of Dollars, but May be Missing Continued Evasion*, GOV'T. ACCOUNTABILITY OFF., GAO-13-318 (Mar. 2013), https://www.gao.gov/assets/660/653369.pdf; *What is BEPS?*, OECD, http://www.oecd.org/tax/beps/about/ (last visited Nov 12, 2020).

36 Jansky & Palansky, *supra* note 7.

37 *International Collaboration to End Tax Avoidance*, OECD, https://www.oecd.org/tax/beps/ (last visited Nov. 13, 2020).

38 Alex Cobham, *Tax avoidance and evasion – The scale of the problem*, TAX JUSTICE NETWORK (Nov. 2017), https://www.taxjustice.net/wp-content/uploads/2017/11/Tax-dodging-the-scale-of-the-problem-TJN-Briefing.pdf.

estimates give us a look into the magnitude of tax revenue loss felt by governments. The commonly-used arm's length principle does not put into effect rigid guidelines, inviting the possibility of abuse by companies employing the principle. There will always be tax dodgers, but a principle that invites avoidance and exploitation should not be the starting point for multinational companies' tax departments.

Fifth, this principle is not effective because "there is no public marketplace when trade occurs between related parties."[39] The arm's length principle simply produces an "educated guess" as to what the related companies believe the transaction is worth, but because the transaction did not occur on an open market, the approximation will continually be inaccurate.[40] Multinational companies consider the tax effects of their business decisions not only for the parent company, but also for all of their subsidiaries; the tax attorneys and accountants for these corporations treat the corporation's own subsidiaries much differently than they would a third-party entity.[41] The arm's length principle does not account for the synergistic relationship between related companies.[42] The assumption underlying the method is that each entity within a multinational corporation acts solely to maximize its own bottom line; however, a major benefit of a multinational entities' structure is that the whole benefits from the collection of the individual parts. "Integrated management processes such as administration, budgeting, and planning" allow companies to save money and therefore have greater effective profits. In fact, "the ability to efficiently internalize these costs is the essence of the MNE structure – and an important source of profitability."[43] A proper integration of multiple entities automatically saves a multinational corporation money, but the arm's length principle does not account for these

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[39] Elizabeth Chorvat, *Forcing Multinationals to Play Fair: Proposals for a Rigorous Transfer Pricing Theory*, 54 ALA. L. REV. 1251, 1256 (2003).

[40] *Id*.

[41] Avi-Yonah, *supra* note 10, at 130.

[42] Chorvat, *supra* note 39.

[43] Avi-Yonah & Benshalom, *supra* note 27, at 379.

gains properly. A multinational group should not be expected to run their corporation as a third party would run their single-entity company.[44]

Finally, the principle is becoming increasingly outdated as it faces the challenge of accounting for intangibles or non-traditional assets. The business world is no longer centered on the industrial factory economy; instead of tangible goods and observable services, many companies' focuses have shifted to complex nontraditional assets and services that are seemingly immeasurable. These nontraditional assets include intangibles, contract rights, and related risks. 'Intangibles' is an ever-growing category, including trade secrets, brand recognition, noncompetition agreements, goodwill, and proprietary methods. In an article discussing the myths and facts of formulary apportionment, the authors, Reuven S. Avi-Yonah and Ilan Benshalom, commented that, "the ownership of the intangible, its finance, and the risk associated with it are all conducted by the same MNE – which makes the process of assigning ownership to one subsidiary rather obscure."[45] The same author likened the idea of designating ownership of an intangible to solely one subsidiary in a multinational corporation to moving items from one pocket to another in the same piece of clothing, removing any real significance to the designation.[46] Similarly, it is pointless to attempt to allocate the rights and risks of an intangible that was created by more than one subsidiary of the corporation. Endeavoring to associate The Coca-Cola Company's Coca-Cola recipe and trade secret to each of its subsidiaries would be inconsequential as all of the subsidiaries have a part in maintaining the quality of the product and benefiting from the success of the company's secret recipe.

In conclusion, the drawbacks of the arm's length principle were best summed up by a tax compliance executive in a UK-based bank who said, "the arm's-length standard is interesting, but it's all

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[44] Josh White, *OECD Looks Beyond the Arm's-Length Principle*, INT'L TAX REV. (Feb. 1, 2019), https://www.internationaltaxreview.com/article/b1fydc48yqvvcz/oecd-looks-beyond-the-arms-length-principle (last visited Nov. 12, 2020).

[45] Avi-Yonah & Benshalom, *supra* note 27, at 384.

[46] *Id*.

hypothetical."[47] The principle effectively limits itself to measuring only "those entities with only routine functions, risks, and assets, using either closely comparable third parties or the entities' own transactions with third parties."[48] For the principle to be employed properly, the realities of a global economy must be considered and used in the measurement of transfer prices.[49]

B. FORMULARY APPORTIONMENT

Formulary apportionment (FA) employs mathematical formulas as a rubric to allocate an MNE's aggregate income to the country in which the production of income took place based on several economic factors.[50] The OECD defines FA as a method that "would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula."[51] This method is based on the idea that the individual entities of an MNE have a shared bottom line.[52] Three factors must be decided when applying FA: (1) which entities make up the unit to be taxed, (2) global profits of the unit, and (3) the formula to allocate the profits.[53] For example, if the BMW Group chose to utilize a formulary apportionment method, it would allocate all of its global profits using a determined formula. The company might choose to split its total profits among the 140 countries it is involved in using a formula of sales, assets, and payroll in equal proportion. This formula is:

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47 White, *supra* note 44.

48 Chorvat, *supra* note 39, at 1262.

49 *Id*. at 1259–62.

50 Fleming Jr. et al., *supra* note 8, at 4.

51 OECD, *supra* note 17, at 39.

52 Charles F. Connolly, *The New Transfer Pricing and Penalty Regulations: Increased Compliance, Increased Burdens, and the Search for a Safe Harbor*, 16 U. PA. J. INT'L BUS. L. 339, 349.

53 OECD, *supra* note 17, at 39.

$$Tax_C = Rate_C \text{ x } \pi_W \left[\frac{1}{3}\left(\frac{\text{Assets(C)}}{\text{Assets(W)}} + \frac{\text{Sales(C)}}{\text{Sales(W)}} + \frac{\text{Payroll(C)}}{\text{Payroll(W)}}\right)\right]$$

Tax = Tax Liability

Rate = Tax Rate

π = Profits

(c) = Country

(W) = Company

To arrive at the tax liability for the corporation in one particular country, BMW would use the formula portrayed above. The country's corporate tax rate is multiplied by the profits of BMW on a worldwide basis. In this hypothetical scenario, BMW chose to apportion their profits using one-third of the assets, sales, and payroll; therefore, each of these factors will be multiplied by a one-third fraction. The numerator for each of the remaining fractions includes only the assets, sales, and payroll in the country at hand; the denominator of the fraction includes the assets, sales, and payroll of the entire corporation, BMW.

First and foremost, formulary apportionment diminishes multinational companies' incentive to shift income from one country to another. Using a formula based on real, economic factors instead of solely the location of the income, formulary apportionment is a solution to the majority of the transfer pricing tax avoidance problem.[54] As long as taxation exists, tax avoidance and evasion will also continue; however, corporations will not be able to sustain their methods of avoiding taxes with the use of a formula in

[54] John T. VanDenburgh, *Closing International Loopholes: Changing the Corporate Tax Base to Effectively Combat Tax Avoidance*, 47 VAL. U. L. REV. 313, 345–46 (2012).

transfer pricing. The current system allows for corporations to shift income primarily through the relocation of intangibles to lower-tax jurisdictions.[55] A formulary apportionment of income does not allow for the location of the intangible to have much effect on their end tax liability.[56]

Second, formulary apportionment would simplify tax systems around the world.[57] The simplification of tax requirements is almost always welcomed with open arms, especially a method that would accomplish it so significantly.[58] Using one formula instead of keeping track of the legal location or form of income will benefit both governments and corporations. Formulary apportionment would decrease the time and resources that the Internal Revenue Service spends on tracking income of multinational corporations. After the initial adjustments, that must be made with any new system, corporations will also be grateful for the simplicity of the new method. A corporation is likely already maintaining records of the location and amounts of their income, but will be able to spend less time pulling information together to report to the taxing agency.

Third, the simplicity and ease of formulary apportionment should also increase transparent compliance.[59] The tax codes of the world are seemingly ever changing; however, reform in this situation would not add to the complexity of the tax subject, it would instead streamline transfer pricing and the tax reporting that accompanies it. Those dealing with the transfer pricing for their corporation or another multinational corporation will know exactly what is expected of them. Instead of battling through the conjectures and hunches of the arm's length principle, the simplified formula allows for valuable corporate time to be spent on other matters. Since the majority of tax avoidance via transfer pricing methods is not done accidentally, the use of a formulary apportionment method

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55 Avi-Yonah & Benshalom, *supra* note 27, at 373.

56 TAX POL'Y CTR., *supra* note 22.

57 VanDenburgh, *supra* note 54, at 346.

58 Emil M. Sunley, *The Pros and Cons of Formulary Apportionment*, CESIFO F. 36, 36 (2002), https://www.ifo.de/DocDL/Forum102-focus6.pdf.

59 VanDenburgh, *supra* note 54, at 346.

will also take away the guesswork that some tax avoiders are hiding behind.[60]

A fourth advantage of formulary apportionment is that a numerical formula will pave the way for consistent tax reporting. Instead of attempting to compare their corporation's transactions to comparable market transactions that may not currently exist, corporations will be able to employ formulas.[61] The use of formulas and consistency go hand in hand; this is a positive effect of FA that is especially useful for the valuation of unique intangibles.

Fifth and finally, countries that have formerly lost tax revenue through corporations' tax avoidance tactics may be able to receive greater amounts of revenue through the use of FA. The United States and other countries that have higher tax rates could begin to earn the amounts that they initially estimate to reap.[62] It's become obvious that multinational corporations located in higher tax jurisdictions are not reporting according to their real economic activity.[63] Lower-tax jurisdictions have benefited monetarily from the arm's length principle, but formulary apportionment methods will not allow for as much income-shifting to these "tax havens."

As with the arm's length principle, commentators have written on the disadvantages of the formulary apportionment method. First, some have argued that the method would cause administrative trouble for MNE's, because of the compilation of data needed to carry out the method. However, this argument is not effective since corporations with an international presence should already have access to this data if they are already utilizing it for other financial matters.[64] Assuming the formulary factors are thoughtfully and purposefully chosen as indicators of profit, the data required by the formula will already be on most, if not all, MNE's balance sheets and income statements.

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[60] Joel Barker, Kwadwo Asare & Sharon Brickman, *Transfer Pricing As A Vehicle In Corporate Tax Avoidance*, 33 THE J. OF APPLIED BUS. RES. 9, 9 (2017).

[61] Avi-Yonah & Benshalom, *supra* note 27, at 377–78.

[62] TAX POL'Y CTR., *supra* note 22.

[63] *Id*.

[64] Avi-Yonah, *supra* note 10, at 156.

Second, it has been suggested that the formulary apportionment method is just as arbitrary as the arm's length standard.[65] Those who argue this point presuppose that countries will be able to pick and choose the formula's factors as they wish; however, as presented in the next point, formulary apportionment will work best with the consensus of countries around the world.[66] The method's structure is successful when countries come together and agree on the factors to put in play. While some commentators have said that formulary apportionment is theoretically subjective, most agree that it is not nearly as arbitrary as the arm's length principle in practice.[67] It will be difficult for multinational corporations to argue with an established formula that takes away their discretion to change the "origin" of their income.

Third, some have written that formulary apportionment is economically impractical in that it will lead to confusion, double taxation, and the violation of promises made in international treaties. These predictive arguments do have some merit, but do not account for the unavoidable fact that no perfect solution to the current tax avoidance issue exists. While confusion is inevitable at the outset of any alteration to a universal system, the resulting formulaic system should bring clarity to transactions involving intangibles and new technology, without complicating other transactions. Others argue that the arm's length standard has been the standard across the globe and attempting to change that will make for an uphill battle.[68]

Avoiding double taxation requires uniformity of involved countries' tax systems and even simultaneous enactment of these systems to avoid double taxation or complete avoidance of tax.[69] Consensus of major economies and countries is needed for the method to properly work.[70] A unilateral decision by any one country

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65 Avi-Yonah & Benshalom, *supra* note 27, at 382.

66 Connolly, *supra* note 52, at 349–50.

67 Avi-Yonah & Benshalom, *supra* note 27, at 382.

68 Connolly, *supra* note 52, at 350.

69 Julie Roin, *Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment*, 61 TAX L. REV. 169, 223 (2008).

70 TAX POL'Y CTR., *supra* note 22.

to put a version of the formulary apportionment method to work will not be effective and will bring negative results: double taxation of some income and no tax for other income.[71] This hypothetical result would be worse than the current international tax system, but is not necessarily realistic. Consensus will be a difficult achievement, however, it is possible. The United States has been known to lead the charge in the international tax world and having a successful example in the States' transfer pricing formulary methods aids in proving the validity of the method.[72] For example, the vast differences between the corporate worlds of Montana and California make an agreement of transfer pricing methods seem impossible, yet there exists an agreement between these two states, and the other forty-eight states in the Uniform Division of Income for Tax Purposes Act.[73] This fact makes the concept of an agreement between countries possible and gives the United States credence to initially propose the idea.[74] Countries across the world are currently considering alternative methods to the arm's length standard, so we are potentially on the cusp of the ideal moment to make a change.[75] The existence of tax treaties between countries suggests a valid argument against the formulary apportionment method.[76] An international tax scholar has recommended a solution to this issue: propose the formulary approach as a discussion draft and invite other countries to enter negotiations, but announce that the approach will be adopted unilaterally if no agreement is reached within a specified time period (e.g., five years).[77] This is one workable resolution and there are others out there.

This paper's proposed method, discussed in Part III, will not result in a stark change in the methods used, so some of these arguments are likely over-exaggerating the possible issues. Tax

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71 *Id.*

72 Connolly, *supra* note 52, at 350.

73 *Construction and Application of Uniform Division of Income for Tax Purposes Act (UDITPA) – Apportionment of Business Income*, 80 A.L.R.6th 325.

74 Avi-Yonah, *supra* note 10, at 157.

75 *Id.* at 159.

76 VanDenburgh, *supra* note 54, at 346.

77 Avi-Yonah, *supra* note 10, at 159.

avoidance will likely continue under any alternative transfer pricing method; however, we must focus on finding the workable method that brings the most positive changes and the least negative side effects.[78] Commentators, as well as myself, believe that the formulary apportionment system will help to accomplish this goal.[79]

C. TRANSFER PRICING METHODS

The final background discussion is in regard to the various methods used to carry out the broader terms "arm's length" and "formulary apportionment." Viewing these individual methods as a progressive series or continuum of slightly different concepts, instead of compartmentalizing each into separate camps, will assist in determining the best method.[80] Since various transfer pricing methods can produce similar results, it is more important to focus on the technical distinctions between each method to discover the best means to measure transfer prices. The traditional arm's length standard and pure formulary apportionment method are the two bookends to this continuum.[81] Another term for the arm's length standard at one extreme of the continuum is the "comparable uncontrolled price" (CUP) method; this takes into consideration similar products or services from unrelated, but similar parties.[82]

Next, the "cost plus" method is used "where semi finished goods are sold between associated parties, where associated parties have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services."[83] This method begins with the expenses of a transaction with a related party, then adds a cost plus mark-up to this amount.[84] This mark-up amount acknowledges each parties' normal functions and operations as well as the risks assumed by each party

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78 Sunley, *supra* note 58, at 36–37.
79 Avi-Yonah & Benshalom, *supra* note 27, at 398.
80 Avi-Yonah, *supra* note 10, at 159.
81 *Id*. at 93.
82 26 C.F.R. § 1.482-3.
83 26 C.F.R. § 1.482-3; OECD, *supra* note 17, at 111.
84 *Id*.

in the transaction.[85] This mark-up represents the gross profit of the transaction and is determined using the ratio of gross profit to cost of goods sold (COGS) for a similar, unrelated party transaction.[86] The resale price method comes next on the continuum of methods. This approach is very much like the cost plus method with the exception that it is used by a reseller, not a manufacturer of the goods.[87] Therefore, the steps are seemingly switched: the method starts with the resale price (the price of the product at sale to an unrelated party after having purchased it from a related party) that is then decreased by the gross profit amount.[88] Again, this gross profit amount accounts for COGS: the expenses, operations, and risks incurred to produce the good.[89]

The next method is the "comparable profit method" (CPM) that relies on data from outside the corporation.[90] This method determines the profit by "comparing it to the average profit earned by a very broad group of corporations operating in the same or a similar industry."[91] The progression of methods comes close to reaching the other bookend, pure formulary apportionment, with the profit split method. This method is different from the pure formulary approach in that comparable transactions are used to allot some of the profits.[92] The profit split method first determines the profits that need to be split among related parties; then, "these profits are divided between the associated enterprises contributions, which should reflect the functions performed, risks incurred[,] and assets used by each enterprise in the controlled transactions."[93] Finally, the other seemingly theoretical bookend is reached: pure formulary apportionment.

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85 UNITED NATIONS, *United Nations Practical Manual on Transfer Pricing for Developing Countries (2017)*, https://www.un.org/esa/ffd/wp-content/uploads/2017/04/Manual-TP-2017.pdf.

86 *Id*. at 174.

87 26 C.F.R. § 1.482-3; Avi-Yonah, *supra* note 10, at 92.

88 OECD, *supra* note 17, at 106–07.

89 *Id.*

90 26 C.F.R. § 1.482-5; UNITED NATIONS, *supra* note 85, at 209.

91 Avi-Yonah, *supra* note 10, at 93.

92 26 C.F.R. § 1.482-6; Avi-Yonah, *supra* note 10, at 94.

93 UNITED NATIONS, *supra* note 85, at 206.

III. AN ALTERNATIVE PROPOSAL

Everywhere you look, there are products, marketing schemes, and industries that implicate or thrive on intangibles. Instead of a company's balance sheet brimming with tangible assets, it is becoming more common to find a company with a large amount of money invested in intangibles. A 2018 report found global intangible value "constitutes 52% of the overall enterprise value of all publicly traded companies worldwide."[94] In addition, the value of intellectual property in American companies is valued at over $5.8 trillion dollars.[95] Technological innovation is a common denominator in expanding industries; it is likely that intangibles such as artificial intelligence and software will be an ever-increasing part of individuals and companies' lives.[96] As mentioned above, the current arm's length standard does not sufficiently account for intangibles, allowing multinational companies to take advantage of the principle; therefore, a change must be made to the transfer pricing rules to decrease tax avoidance. A complete overhaul is unnecessary; there are few tax professionals who wish to totally rebuild the transfer pricing system.[97] Until alterations are made, the arm's length principle will continue to be the norm. A conceivable method must be largely agreed upon before replacing the established rule. As the former director of tax at the OECD says, "it's like Brexit, you can't abandon ship without a clear plan or credible

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[94] CORPORATE EXCELLENCE, *Global Intangible Value Exceeds US$50 Trillion for the First Time* (2018), https://www.corporateexcellence.org/en/resource/global-intangible-value-exceeds-us50-trillion-for/2315f4c0-da19-4426-792a-4bf9dbb5e99e (last visited Nov. 13, 2020).

[95] Christopher Heer & Daryna Kutsyna, *Statistics on the Value and Importance of Intellectual Property,* HEER L. (Oct. 19, 2019), https://www.heerlaw.com/value-intellectual-property-statistics (last visited Nov. 13, 2020).

[96] Jared Hecht, *How Technology Is Driving Change In Almost Every Major Industry*, FORBES (Nov. 30, 2018), https://www.forbes.com/sites/jaredhecht/2018/11/30/how-technology-is-driving-change-in-almost-every-major-industry/#157a2b672f6f (last visited Nov. 13, 2020).

[97] White, *supra* note 44.

alternative."[98] The same former director also created a list of prerequisites for an alternative system; this list consists of the following three requirements: "Is the alternative principle-based? Is it feasible in administrative terms? Can you reach a consensus on making it policy?"[99] With these stipulations in mind, this paper proposes a solution: the international tax regime should employ the arm's length standard as currently prescribed, but utilize a residual profit split method, described in detail below, in circumstances in which the arm's length standard is inadequate.

This paper's solution to the current international search for a new and improved standard is a hybrid system. This system allows the arm's length principle to shine in the areas for which it was established in the first place: "it was originally intended to be a credible, efficient, and easily administered benchmark for allocating MNE income."[100] Keeping the arm's length principle at the forefront of transfer pricing obviously addresses all three of the aforementioned prerequisites for an alternative solution, mainly because it was established for those very reasons. Therefore, attention must be given to whether this paper's proposed supplement to the arm's length principle, the residual profit split method, successfully achieves these requirements.

The U.S. Treasury Regulations allocate profit or loss through the use of the residual profit split method ("RPSM") in two steps. First, it allocates "operating income to each party to the controlled transactions to provide a market return for its routine contributions to the relevant business activity."[101] Routine contributions are then defined by the regulations as a business activity that is the same or similar to activities unrelated parties in a similar market would conduct.[102] Second, "the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their nonroutine contributions to the relevant business activity."[103] Regarding the second step, the IRS notes that simply because a

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98 *Id.*
99 *Id.*
100 Avi-Yonah & Benshalom, *supra* note 27.
101 26 U.S.C. § 1.482-6(c)(3)(i)(A).
102 *Id*.
103 26 U.S.C. § 1.482-6(c)(3)(i)(B).

transaction involves intangible assets does not imply that it is a non-routine contribution; if market data is available, companies may be able to treat these transactions as routine and value them accordingly.[104] This paper's proposal revolves around the second step in the residual profit split method. The RPSM's purpose is to evaluate whether the allocation of income is in keeping with the arm's length standard—the value assigned to each taxpayer should also indicate "the functions performed, risks assumed, and resources employed by each participant in the relevant business activity."[105] The residual profit split method is best applied to transactions involving intangible property since it adequately accounts for such non-routine transactions in the second step of the process.[106] The regulations provide several differing methods for the measurement of non-routine intangible property; however, as discussed below, reducing the number of variables will be beneficial for all parties utilizing the method.

The residual profit or loss ("residual income") is allocated by different companies and countries using several varying formulas. These formulas allocate income based on a ratio of economic factors in different jurisdictions.[107] The possible inclusion and exclusion of factors in these formulas have resulted in a great deal of scholarly debate. While there is no foolproof set of factors, effort should be given to find factors that are not easy to manipulate but still maintain their effectiveness.[108] Though it may seem cynical, it is likely that the moment the residual profit split method's formula is agreed upon, companies will commence attempts at exploiting the factors for their own benefit.[109] The question is not if manipulation to the formula will occur, but how the corporation will undertake abuse to the system. While taxes are routinely considered in business decisions, the outcome with the lowest taxes may not always prevail against other non-tax considerations. A corporation will only

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104 *Id.*
105 26 U.S.C. § 1.482-6(a)-(b).
106 26 U.S.C. § 1.482-6(c)(3)(i)(B)(2).
107 Roin, *supra* note 69, at 202.
108 Avi-Yonah & Benshalom, *supra* note 27, at 391.
109 *Id*.

attempt to manipulate the individual components of the formula if it is beneficial for the organization; so, if manipulation is costly to the organization or the return is insubstantial, the organization will not mess with the factors.[110] Logically, the more each factor is susceptible to manipulation, the application of the formulary apportionment becomes less effective.[111] To minimize possible manipulation and allow for the formula's greatest efficacy in apportioning income, careful consideration should be given to the individual factors utilized.[112] Ideally, if all companies adhere to the residual profit split method in practice, the factors that are ultimately chosen do not make much difference.[113]

Among the most common factors adopted in the residual profit split method are sales, assets, and payroll, but other cost-based factors such as expenses for research and development or marketing have been utilized as well.[114] Because of the close proximity and integrated business between the individual states, formulary apportionment, specifically the profit split method, has been promoted for use in transfer pricing between state jurisdictions.[115] The states' have shown a preference for two sets of factors: the "Massachusetts formula" and a sales-based formula. The "Massachusetts formula" weighs property, payroll, and sales in equal proportion and allocates the corporation's income from that jurisdiction accordingly.[116] A sales-based formula is even more self-explanatory: states use only sales to allocate residual income.[117]

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[110] *Id.* at 390.

[111] Roin, *supra* note 69, at 204.

[112] *Id*.

[113] Avi-Yonah, *supra* note 12, at 1348.

[114] Jason Eberhardt, *OECD Issues Final Revised Guidance on the Profit Split Method*, BKD THOUGHTWARE, (Sept. 18, 2018), https://www.bkd.com/article/2018/09/oecd-issues-final-revised-guidance-profit-split-method.

[115] TAX POL'Y CTR., *supra* note 22.

[116] 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*, 22 DUKE J. COMP. & INT'L L. 425, 444 (2012).

[117] Roin, *supra* note 69, at 202.

The mobility of each factor must be considered, because as many of the states came to realize, factors relating to production are easily moved.[118] Similarly, inventories and the value of goods can be marked down in the corporation's records to take advantage of the set formula; because of their nature, intangible items can also be effortlessly left off the corporation's balance sheet.[119] Some argue that property does not generate accurate allocation of income since property is challenging to properly value; however, employees are not easily moved, so payroll might seem to be a relatively safe factor.[120] Taking the whole picture of the corporation into consideration, many corporations' plans to put workers, inventories, and assets in a jurisdiction with higher taxes will be deterred if the formula's factors focus on those items.[121] This has been described as an "implicit tax" on the individual factors and will have an effect on a corporation's decisions.[122] Conversely, a corporation is not likely to have a desire to move sales from one jurisdiction to another; multinational corporations want to sell as many goods and services in every jurisdiction in which they have a presence, regardless of the tax expense.[123] This attribute of sales has been termed its "inelasticity"; a corporation does not have a great incentive to maneuver sales from one country to another.[124]

This paper proposes the sole factor of sales to allocate income via the residual profit split method. Diverse factors for the method—those mentioned above and additional, more obscure factors utilized by a few—make manipulation by corporations more likely and do not solve the issue of tax avoidance as successfully as the use of the sales factor. The prevalent and successful usage of the sales factor

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118 *Id*. at 203.

119 Avi-Yonah & Benshalom, *supra* note 27, at 391.

120 Susan C. Morse, *Revisiting Global Formulary Apportionment*, 29 VA. TAX REV. 593, 594 (2010).

121 Reuven S. Avi-Yonah, Kimberly A. Clausing & Michael C. Durst, *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split*, 9 FLA. TAX REV. 497, 509 (2009).

122 *Id*.

123 *Id*.

124 Morse, *supra* note 120, at 605.

in the United States bolsters this idea.[125] The use of sales addresses the issue of allocation of income related to intangibles by using the customer's location instead of giving corporations the opportunity to "relocate" the intangible asset to a lower-tax jurisdiction and escape taxes.[126] Outsourcing, independent contractors, and employee leasing could be utilized to lighten the tax burden for corporations; however, using sales to allocate income prevents this strategy.[127] Thus, sales as the exclusive factor eliminates any possible ties from the location of a corporation to the income statement of the corporation; the factor takes the power to manipulate income and taxes from corporations and levels the playing field for corporations around the world. Developing nations will challenge the utilization of only sales in the allocation of profits.[128] These countries contribute to the production of income for MNE's by other means, such as property used for production and a ready workforce, but would be precluded from collecting tax revenue in a sales-based apportionment method.[129] A recent article by Joseph Bankman, Mitchell Kane, and Alan Sykes considers policies currently employed by non-resident MNE's to reclaim some of the revenue withheld from their countries; these methods include regulation of prices, tariffs, and enterprises owned by the government.[130] If a sale-based formulary apportionment method is adopted, developing nations do have other means by which to collect revenue from production within their borders.

Practically, in addition to the simplicity of formulary apportionment, a single factor makes the method even more straightforward. Large corporations should be prepared for complicated principles and formulas; however, the simplification of

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125 *Id*.

126 Orly Mazur, *Transfer Pricing Challenges in the Cloud*, 57 B.C.L. REV. 643, 690–91 (2016).

127 Roin, *supra* note 69, at 205.

128 Joseph Bankman, Mitchell Kane & Alan O Sykes, *Collecting the Rent: The Global Battle to Capture MNE Profits* 1–48 (NYU Law and Economics Research Paper No. 18–38, Stanford Law and Economics Olin Working Paper No. 527, 2018), https://ssrn.com/abstract=3273112, archived at https://perma.cc/9ZVM-993G.

129 *Id*.

130 *Id*.

the process will be beneficial for any party involved.[131] Corporations, large or small, and taxing authorities will be grateful for a less demanding and uncomplicated formula.[132] Countries with large markets abroad, such as India, United States, and Brazil, are likely to encourage the switch to a residual profit split method based on the destination of the corporation's sales.[133] These are the most noticeable and predictable results of changing to a hybrid transfer pricing system for international income tax allocation.

The introduction of the residual profit split method is, of course, not a perfect solution, but it is a real-world solution that is workable and fixes current issues. The most noticeable flaw of the arm's length principle is that it does not properly allocate multinational company's income in situations with income sources that are difficult to allocate. As the residual profit split method does not rely on comparable transactions for transfer pricing, it is an obvious answer to the issue presented.[134] The cost sharing method also does not depend on comparable transactions, but it is important to choose a single method for use in transactions with incomparable data. Granting each multinational corporation the opportunity to select the method that plays to their advantage would create a chaotic and unpredictable international tax regime.[135] While the cost sharing method's income allocation is not contingent on the availability of comparable transactions, this technique has been discredited for continually understating income, especially for companies in the United States.[136] Therefore, this paper proposes the use of the

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[131] Josh White, *Profit Split Method in IP Strategy Grows in Popularity*, INT'L TAX REV. (June 12, 2019), https://www.internationaltaxreview.com/article/b1fydc2l7gthjm/profit-split-method-in-ip-strategy-grows-in-popularity (last visited Nov. 13, 2020).

[132] Avi-Yonah, Clausing & Durst, *supra* note 121.

[133] Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347, 418 (2013).

[134] Fleming Jr. et al., *supra* note 8, at 55.

[135] Sunley, *supra* note 58, at 36.

[136] Fleming Jr. et al., *supra* note 8, at 55.

residual profit split method to properly allocate income without sacrificing accuracy.

The reasons to alter the current system are convincing to many tax scholars and professionals; however, a proposal for change is always met with at least some opposition. While there are a few valid arguments against a hybrid combination of the arm's length principle and the residual profit split method, the benefits of the proposed method greatly outweigh the suggested disadvantages it could bring. As mentioned above, this proposal seeks to address the current issues the arm's length principle generates, but, because of the complexity and fallibility of the international tax world, it is impossible to produce a flawless proposition.[137] First, some commentators suggest that any system with formulary apportionment attributes could deliver arbitrary results.[138] As pointed out earlier in this paper, the arm's length principle is noticeably unpredictable and inconsistent in its application; using the residual profit split will decrease the possibility of arbitrariness. One commentator points out that, "to a large extent, the choice of any convention is always arbitrary."[139] Because formulary apportionment solutions are based on economic measurements, it will produce less arbitrary results than the arm's length principle in valuing items without similarities to other products.[140] Along these lines, many believe that certain countries and specific industries will benefit more than others from a sales-driven formula.[141] Some believe that major exporting companies headquartered in the United States will gain substantially.[142] Others are positive that a proposed method of this type is the most appropriate method for the oil and gas industry, but that it would ultimately burden the industry with

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137 Avi-Yonah & Benshalom, *supra* note 27, at 636.

138 Avi-Yonah, Clausing & Durst, *supra* note 121, at 516.

139 Lepard, *supra* note 21, at 117.

140 Sienna C. White, *Cost Sharing Agreements & the Arm's Length Standard: A Matter of Statutory Interpretation?*, 19 FLA. TAX REV. 191, 220 (2016).

141 *Id*.

142 Avi-Yonah, Clausing & Durst, *supra* note 121, at 516.

greater tax liabilities.[143] It is important to remember that the current principle, and any suggested alternative, will have various effects on different countries, corporations, stakeholders, and industries; however, it is impossible to appease every party.

Many suggest that the transition to a new method will be a challenge. Of course, an adjustment to the current system may take some time for countries and companies; however, since the majority of the proposal utilizes the arm's length standard as it currently stands, the transition should be relatively seamless. With at least 150 countries employing transfer pricing regimes, a change in the system will take coordination and time.[144] Several commentators predict that the United States' adoption of a new transfer pricing system would likely encourage other countries to follow suit.[145] The United States has been a leader in various fields including taxation; even the current transfer pricing regulations were first approved and adopted by the United States.[146] Finally, some believe that a different transfer pricing system will only cause issues in the interaction between countries with disparate taxation systems. This suggestion neglects to consider that the current system was once proposed to countries with differing tax systems but has been workable for the past several years. While there are some obstacles to introducing the proposed arm's length principle with the residual profit split method into the world's economy, this new method will alleviate many of the issues that are prevalent with our current method.

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[143] ITR Correspondent, *Profit Splits and Their Application in the Energy and Resources Sector*, INT'L TAX REV. (Mar. 5, 2019), https://www.internationaltaxreview.com/article/b1f7mxsf1rmwkv/profit-splits-and-their-application-in-the-energy-and-resources-sector (last visited Nov. 13, 2020); Avi-Yonah, Clausing & Durst, *supra* note 121, at 524.

[144] Robert Feinschreiber, *Applying Production-Based Transfer Pricing*, ACCT. TODAY (July 6, 2018), https://www.accountingtoday.com/opinion/applying-production-based-transfer-pricing (last visited Nov. 13, 2020).

[145] Avi-Yonah, Clausing & Durst, *supra* note 121, at 519–20.

[146] *Id*.

IV. RESIDUAL PROFIT SPLIT APPLIED TO BMW

The Upstate of South Carolina has seen substantial growth in the past few years: the Greenville-Spartanburg area has seen an increase, not only in popularity and population, but also in manufacturing and industry.[147] As with most growth, this beneficial expansion for the economy did not happen accidentally. South Carolina boasts of advantages to relocating or introducing ventures to the state, including fees in lieu of taxes for companies that invest at least $2.5 million in the state of South Carolina.[148] Regardless of the tax benefits, South Carolina, specifically the Upstate cities, boasts of an environment conducive to the manufacturing industry. In a 2019 report produced by the Center for Business and Economic Research evaluating relevant factors such as each states' labor force quality, transportation infrastructure, and cost of doing business, South Carolina received a score of A for manufacturing industry health.[149]

BMW's expansion to the United States through the establishment of its manufacturing plant in South Carolina naturally brought an incredible amount of industry with it. Automotive manufacturing makes up the majority of the manufacturing industry in the Upstate; this portion of South Carolina produces practically every imaginable part of an automobile including Michelin tires, Draexlmaier vehicle electric systems, Roechling air intake systems, and BMW's X-line vehicles. The majority of the automotive manufacturers in the Upstate are members of multinational corporations; many of the Upstate locations are simply production

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[147] Smallare, *Greenville's Growth Rate*, GVLTODAY (Nov. 11, 2019), https://gvltoday.6amcity.com/greenville-sc-growth-rate/ (last visited Nov. 13, 2020); Dustin Waters, *Manufacturing Remains The Top Economic Driver in Spartanburg*, GREENVILLE BUS. MAG. (May 6, 2019), http://www.greenvillebusinessmag.com/2019/05/06/197042/manufacturing-remains-the-top-economic-driver-in-spartanburg (last visited Nov. 13, 2020).

[148] S.C. DEP'T. OF REVENUE, *Fee in Lieu*, https://dor.sc.gov/tax/fee-in-lieu (last visited Nov. 13, 2020).

[149] Michael J. Hicks, Srikant Deveraj & Riley Liechty, *Manufacturing Scorecard 2019*, CTR. FOR BUS. AND ECON. RES., https://mfgscorecard.cberdata.org/files/National2019.pdf.

plants or operational offices for a much larger company headquartered in France or Germany.[150] With so many ties to multinational corporations in its counties, the Upstate of South Carolina's growth could be affected by a change in the transfer pricing regulations. The multinational corporations with a presence in the Greenville-Spartanburg area of South Carolina chose the location with their bottom line in mind, considering tax advantages and disadvantages. The addition of the residual profit split method to their transfer pricing calculations may be beneficial or costly since no matter what transfer pricing method each corporation is currently employing, a change in the standard will influence every corporation's net income amount in some fashion.[151]

The profit of many of the MNE manufacturing companies in the Upstate is based in part on intangible assets. For instance, the brand recognition of BMW's emblem adorned with sky blue and white resembling the Bavarian flag is incomparable to other companies' branding.[152] Similarly, the familiarity of the three initials, B.M.W., instead of the company's actual name, Bayerische Motoren Werke, is an asset to the company that is difficult to measure.[153] Just as BMW has intangibles, Roechling Group out of Duncan, SC creates customized plastics for automotive, medical, and industrial uses that are patented and tailor-made for specific clients.[154] These patented

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[150] UPSTATE SC ALLIANCE, *Major Employers*, https://www.upstatescalliance.com/data-resources/major-employers/ (last visited Nov. 13, 2020).

[151] John McKinley & John Owsley, *Transfer Pricing and Its Effect on Financial Reporting; Multinational Companies Face High-risk Tax Accounting*, J. OF ACCT. (Oct. 1, 2013), https://www.journalofaccountancy.com/issues/2013/oct/20137721.html.

[152] Christopher Parr, *The Origin of the BMW Logo*, BUS. INSIDER, (May 12, 2012, 8:47 PM), https://www.businessinsider.com/the-origin-of-the-bmw-logo-2012-5 (last visited Nov. 13, 2020).

[153] Roger Sinclair & Kevin Keller, *A Case For Brands as Assets: Acquired and Internally Developed*, 21 J. BRAND MANAG. 286, 288 (2014), https://link.springer.com/article/10.1057/bm.2014.8.

[154] ROCHLING GROUP, *About the Group*, https://www.roechling.com/roechling-group/about-the-group (last visited Nov. 13, 2020).

plastics are different from other companies' manufactured plastics because of the individuality of the products and communication between the clients and the company in producing the plastic.[155] After reviewing the possible processes, many have pronounced the residual profit split method the superior method for the measurement of intangibles like those owned by BMW and Roechling.[156]

In application, companies like BMW would follow the steps outlined by the Treasury Regulations when valuing their incomparable goods or processes, such as BMW's patented method and apparatus for holding an assembly for mounting on structural parts.[157] The company has conceived and patented several inventions, but this paper will use only one for the purpose of application. The BMW Group, headquartered in Munich, Germany, (hereinafter referred to as 'BMW Germany') has patented the assembly method and apparatus, yet the BMW manufacturing plant in Spartanburg, South Carolina (hereinafter referred to as 'BMW SC') utilizes both. To value the process and mechanism protected by a patent, the BMW Group should use the four steps of the residual profit split method. First, the residual profit split method requires a determination of the routine and non-routine contributions from each party.[158] Both parties provide non-routine contributions: BMW Germany through the development and patent of the assembly method and apparatus and BMW SC through the adaptation of the method and use of the apparatus in its assembly line and facilities. Next, we should determine if the residual profit split method is the best method for measuring this transaction.[159] Non-routine contributions make it impossible to identify market valuations for these contributions; therefore, the residual profit split method is the

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155 *Id*.

156 Stanley I. Langbein, *United States Policy and the Taxation of International Intangible Income*, 50 U. MIAMI INTER-AM. L. REV. 277, 326 (2019).

157 BMW AG, *Method and Apparatus for Holding an Assembly for Mounting on Structural Parts*, JUSTIA (Apr. 13, 1992), https://patents.justia.com/patent/5346029 (last visited Nov. 13, 2020).

158 26 U.S.C. § 1.482-6(c)(3)(i)(A).

159 *Id*.

best method for this transaction.[160] We should allocate income to the parties based on routine considerations.[161] While most transactions between multinational entities involve both routine and non-routine contributions, this simple illustration considers only a non-routine contribution without any routine elements. In a more intricate transaction, routine contributions could also include manufacturing or distribution operations.[162] Finally, we arrive at the most important step in the IRS' guidance for the residual profit split method that requires that we allocate residual profit or loss to the parties based on non-routine contributions.[163]

The residual profit is the amount that remains after having subtracted the return on routine contributions calculated in the third step. In this example, the residual profit can be traced solely to intangibles. For the sake of illustration, assume that BMW Germany contributes 80% of the R&D expenses that cultivate the manufacturing assembly method and apparatus for use and BMW SC contributes 20% of the R&D expenses in developing the method for use in the Upstate South Carolina plant. Using sales as our denominator, BMW Germany will be apportioned 80% of the residual profit from the intangibles and BMW will be allotted 20% of the residual profit.

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The use of the formulary profit split allows companies like the BMW Group to accurately and methodically value their contributions among several related entities. BMW's assembly line method and apparatus is unlike other corporations' processes; it is a unique, patented, and seemingly immeasurable intangible. While the arm's length standard is not well-suited for measuring such

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160 *Id*.

161 *Id*.

162 David Bell et al., *Profit Split Method: New OECD Guidance and Practical Applications*, DELOITTE (Nov 27, 2018), https://www2.deloitte.com/content/dam/Deloitte/in/Documents/tax/in-tax-profit-split-method-new-oecd-guidance-practical-applications-noexp.pdf.

163 26 U.S.C. § 1.482-6(c)(3)(i)(B).

intangibles, the addition of the residual profit split method to the current norm allows for a proper allocation of income to each country in which a corporation operates.

V. CONCLUSION

The increasing number of intangible assets on multinational corporations' balance sheets and the rise of tax avoidance in transfer pricing scenarios require an evaluation of the current transfer pricing standard. The combination of the arm's length principle with the residual profit split method is a viable and effective solution to these issues. The arm's length principle does have advantages—the method is best applied to transactions involving comparable assets. The use of a formulary apportionment method as a supplement to the arm's length principle in valuing transfers of goods or intangibles in which there is no corresponding good responds to the current valuation issues many tax scholars and professionals are attempting to resolve. The inclusion of a formula will also deter tax avoidance and evasion for the good of both countries and companies. Specifically utilizing the residual profit split method further responds to concerns of arbitrariness and inaccuracy that other methods have exhibited. The proposed transfer pricing method capitalizes on the most valuable features of both the arm's length standard and the formulary apportionment approach to solve prevalent issues caused by the current method.