Consistency, Sunshine, Privacy, Secret Law, and the APA Program

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In this report, the authors address the barriers to and the need for disclosure of more information on advance pricing agreements as well as other ways to better administer transfer pricing laws.

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I. Introduction

Uniform treatment of similarly situated persons is the essence of law itself.[1]

Sunshine is said to be the best of disinfectants.[2]

The public interest outweighs private interests where an agency's performance of its statutory duties is at issue.[3]

Secret law is an abomination.[4]

Transfer pricing is the Bermuda Triangle of our tax law. Once one enters the triangle, whether by design or by chance, a path through it can be elusive because pricing problems are complex, the stakes are high, and outcomes are driven by hard-to-reconcile perspectives on the facts and the not necessarily enlightened self-interest of parties that often include two opposing governments as well as the taxpayer. The triangle also distorts economic principles. An "interquartile range" based on a few comparables can substitute for statistical validity.[5] Discount rates determined on an enterprise basis can apply to much riskier investments.[6] And otherwise uncontroversial propositions — such as a

[1]*BMW of North America Inc. v. Gore*, 517 U.S. 559, 587 (1996) (Breyer, J., concurring) (ellipses omitted).

[2]Louis D. Brandeis, *Other People's Money and How the Bankers Use It*, 92 (1914).

[3]*U.S. Dept. of Justice v. Reporters Committee*, 489 U.S. 749, 772 (1989) (internal quotation marks and ellipsis omitted).

[4]*Tax Analysts & Advocates v. IRS*, 362 F. Supp. 1298, 1310 (D.D.C. 1973) (quoting Kenneth Culp Davis, *Administrative Law Treatise*, section 3A.12 (1970 supp.)).

[5]*See* reg. section 1.482-1(e)(2)(iii).

[6]Proposed cost-sharing regulations issued in 2005 provided that a publicly traded taxpayer's weighted average cost of capital (WACC) was the appropriate starting point for deriving an appropriate discount rate to value buy-in payments (called preliminary or contemporaneous transaction payments). *See generally* prop. reg. section 1.482-7(g) and (i). References to WACC were removed in the temporary cost-sharing regulations issued in January 2009. *See generally* reg. section 1.482-7T(g) and (i).

patent on the world's most important drug having great value — can be disputed.[7]

Nor does the simply stated and intuitively correct arm's-length principle provide a reliable path out of the triangle, for the regulations do not seek to fully define it. Rather, they often seem to offer an anti-definition: The principles advanced (for example, ''contractual arrangements . . . will be respected'') may conflict with other principles (for example, arrangements can be overturned for lack of ''economic substance''), and the regulations offer taxpayers limited practical guidance for reconciling these conflicts. They instead emphasize the commissioner's discretion to choose (for example, ''the Commissioner may require . . . ,'' or the district director disregards . . . ''),[8] while providing unweighted and unprioritized lists of often-conflicting factors to consider.[9]

Each incarnation of transfer pricing regulations has failed to establish a reliable framework for resolving key real-world problems, and each has led to a further attempt to write definitive rules.[10] Unfortunately, the successive iterations' focus on increasingly detailed but enduringly abstract definitions of the arm's-length standard is like repeated attempts to nail gelatin to the wall by using successively larger numbers of nails. What is missing is not adequate definitions of principles, but rather publicly available applications of them to real-life facts. Understandably, the examples in the regulations avoid the complexity usually encountered in a real matter, but the consequence is that they tend to fly at 50,000 feet instead of guiding one to a smooth landing. They often seek to establish the commissioner's supposed statutory discretion to bind the taxpayer to a particular interpretation of facts while ignoring the reality that the commissioner's discretion is not to choose the operative facts, but rather to determine an arm's-length result for whatever the operative facts are.

Although transfer pricing cases are reasonably common, an obvious litmus test of a successful regulation — a court's application of it to sustain either the IRS's or a taxpayer's litigating position — is rare. Even after trial, there is usually little overlap either in the parties' positions or in their interpretations of the facts or law. And a sense of frustration often permeates the court's usually obtuse opinion, the bulk of which is given over to a detailed statement of the confusing facts, an explanation of the reasons for rejecting both sides' proposed outcomes, and a Solomonic pronouncement of result narrowly tied to the unique facts before the court or the application of presumptions precipitated by a failure of proof.

Guidance that sets forth complex real-world facts, chooses a method acceptable to both the administrator and the taxpayer, and provides financial assumptions and expected results would benefit taxpayers, administrators, and judges by showing the paths that some have taken through an otherwise directionless wilderness. Such guidance would also discourage particularly egregious detours. The body of examples would be far more valuable than further test-tube definitions of regulatory principles without a demonstration of their practical application to real-world facts or further judicial opinions focused primarily on the resolution of factual disagreements.

The advance pricing agreement program is the sole instance in which the IRS applies transfer pricing principles to complex real-world fact situations, and taxpayers treat the resulting prospective allocations of profit as binding. There, taxpayers disclose their facts and analysis to experienced professionals within the IRS Office of Chief Counsel. Once the parties agree on the facts, the IRS exercises its statutory discretion to determine a pricing methodology for future periods, and the taxpayer formally agrees.[11]

In some industries, many agreements have been completed.[12] The substance of these APAs could establish key categories of facts and data, agreed approaches to interpreting them, and acceptable methodologies for assigning arm's-length returns to functions such as manufacturing and distribution in these and other industries. That information could in principle provide a real-world framework for discussing and perhaps resolving difficult cases. There are statutory limitations on what information could be released, but the IRS has stopped far short of those limitations by choosing as a practical matter to release virtually no substantive information concerning completed APAs.

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[7] *See infra* at 673-674.

[8] Reg. section 1.482-1(d)(3)(iii)(C), Example 4. The title ''district director'' was used under an IRS organizational structure that no longer exists. However, the transfer pricing regulations continue to use that title.

[9] Reg. section 1.482-1(d)(3)(iii)(B). (Reg. section 1.482-1(d)(3)(ii)(B), reg. section 1.482-1(d)(3)(ii)(C), Example 4.)

[10] The transfer pricing regulations now consume 188 pages, and proposed regulations another 16 pages, in CCH's desk set of federal income tax regulations.

[11] *See* Rev. Proc. 2006-9, 2006-1 C.B. 278, *Doc 2005-25514*, *2005 TNT 243-8*, *as modified by* Rev. Proc. 2008-31, 2008-1 C.B. 1133, *Doc 2008-11247*, *2008 TNT 100-7*.

[12] In May 2005 the IRS announced an initiative to increase specialization in the APA program. Five categories of cases were selected for specialization, including cases involving the automotive and pharmaceutical industries. *See* Announcement 2007-31, 2007-1 C.B. 769, *Doc 2007-4969*, *2007 TNT 39-13*.

This report addresses the barriers to and need for disclosure of more information concerning APAs. It begins by examining the unique status of APAs under the Freedom of Information Act[13] and section 6103. In principle, APAs prospectively set transfer pricing methods (TPMs) for the related-party transactions of successful applicants, but the parties sometimes also use those TPMs retrospectively to resolve pending audit issues. To the extent that an APA reflects the IRS's approval of a TPM for future periods, it provides the IRS's legal position on the facts represented by the applicant in the same way that a private letter ruling does.[14] To the extent that an APA reflects this position for past periods, it is similar to technical advice memorandums[15] and field service advice.[16] An APA also constitutes an exercise of the commissioner's statutory discretion under section 482 to choose among reasonable approaches to determine an arm's-length result. Prospective legal advice, legal assessments that resolve existing disputes, and discretionary choices in applying statutory principles demonstrate the IRS's working law,[17] and they are relevant to any analysis of whether the IRS is administering transfer pricing law reasonably and consistently, rather than in an arbitrary and capricious fashion.[18] Disclosing them would help guide taxpayers in their efforts to comply with the law and would help ensure that similarly situated taxpayers receive similar treatment.[19] It also would help transfer pricing law develop in ways that would benefit all parties.

FOIA requires the disclosure of an agency's working law, subject to some narrow statutory exemptions. In making those disclosures, the IRS must protect a taxpayer's right to the privacy of so-called return information as detailed in sections 6103 and 6110. Thus, while FOIA generally requires disclosure of taxpayer-specific legal guidance such as letter rulings, technical advice memorandums, field service advice, general counsel memorandums, and chief counsel advice, the IRS must redact some information under section 6110 before releasing those documents for publication. In 1999 the IRS announced that APAs constituted legal advice for which disclosure was required after redaction of sensitive information.[20] Before any APAs actually were disclosed, however, Congress added APAs as a new category of return information under section 6103, thus completely exempting them from routine disclosure.[21]

Congressional concern that IRS working law should be disclosed led to an attempt to balance this exemption with an alternative reporting regime[22] that requires the IRS to publish an annual report on the APA program. The IRS has chosen not to use this requirement as an opportunity to disclose its working law, and thus the annual reports issued over the last decade reveal little of substance. The choice to conceal the substance of APAs is a serious problem, because the IRS's current approach to the administration of transfer-pricing law uses inconsistent standards. The IRS and taxpayers reach presumably reasonable but undisclosed results through the APA process, while in audit and litigation, IRS auditors and trial counsel often take extreme positions without regard to — and presumably without knowledge of — the more reasonable approaches employed in the APA program.[23] By withholding the substantive content of APAs and pursuing a scorched-earth strategy in litigated transfer pricing cases, the IRS has imposed unnecessary costs on many taxpayers, inhibited the development of transfer pricing law, and abdicated its

[13]5 U.S.C. section 552 (2010).

[14]A private letter ruling is a written response issued to a taxpayer by the IRS National Office that interprets and applies tax laws to a specific set of facts. *See* reg. section 301.6110-2(d).

[15]A technical advice memorandum is a written statement issued by the National Office to a district director in connection with the examination of a taxpayer's return or consideration of a taxpayer's claim for refund or credit. *See* reg. section 301.6110-2(f).

[16]Field service advice is case-specific advice provided to examiners by the associate chief counsel. *See* Internal Revenue Manual section 4.8.8.12.3(1).

[17]An agency's working law has been defined as "interpretations of established policy on which the agency relies in discharging its regulatory responsibilities." *Tax Analysts v. IRS*, 294 F.3d 71, 81 (D.C. Cir. 2002), *Doc 2002-14346, 2002 TNT 116-8*.

[18]Although Congress has limited the IRS's ability to disclose information regarding APAs (see *infra* at 665-668), it was given significant latitude to disclose substantive information. Unfortunately, the IRS has opted to provide minimal information that is of little use to taxpayers. *See infra* at 668-669, and 680.

[19]*See, e.g., Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 544 (1979) ("Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax"); *Commissioner v. Idaho Power Co.*, 481 U.S. 1, 14 (1974) (statute interpreted to avoid "disparate treatment among

(Footnote continued in next column.)

taxpayers"); *Bunce v. United States*, 28 Fed. Cl. 500, 508 (1993), *Doc 93-6628, 93 TNT 125-17* ("A duty of administrative consistency certainly exists; the tax laws must be interpreted and applied as uniformly as possible"), *aff'd*, 26 F.3d 138 (Fed. Cir. 1994), *Doc 94-4196, 94 TNT 79-26*; *Transco Exploration v. Commissioner*, 949 F.2d 837, 840 (5th Cir. 1992) ("Although the Commissioner is entitled to change his mind, he ought to do more than stride to the dais and simply argue in the opposite direction").

[20]IR-1999-05, *Doc 1999-1768, 1999 TNT 7-16*.

[21]Ticket to Work and Work Incentives Improvement Act of 1999 (P.L. 106-170), section 521(b).

[22]*Id.*

[23]This is not to suggest that taxpayers always maintain reasonable positions. However, a critique of taxpayer compliance is beyond the scope of this report.

leadership position in the development of transnational transfer pricing principles. Its extensive publication of regulations over the last two decades is an inadequate substitute for disclosure of the working law applied in its APA program, because the regulations do not deal with the real-life fact situations with which the program grapples. Within the framework of existing law, the IRS can and should take several concrete steps to correct these problems.

II. The Sun Rises — Birth of FOIA

The treatment of APAs under FOIA is anomalous. Understanding the depth of this anomaly requires an understanding of the background and purposes of FOIA and its application to other forms of taxpayer-specific guidance.

A. Disclosure Before FOIA

The predecessor to FOIA, the 1946 Administrative Procedure Act, provided for the disclosure of matters of official record by federal agencies to persons ''properly and directly concerned'' unless ''otherwise required by statute'' and unless the information was found to be ''confidential for good cause found.''[24] In enacting that statute, Congress explained that ''administrative operations and procedures are public property that the general public, rather than a few specialists or lobbyists, is entitled to know or have ready means of knowing with definiteness and assurance.''[25]

Shortly after enactment, the Department of Justice issued a memorandum explaining that, in determining which agency records should be publicly available, ''Congress had left up to each agency the decision on what information about the agency's actions was to be classed as 'official records.'''[26] As a result, agencies began denying requests for unpublished information by finding that the withholding of documents was ''in the public interest'' or ''for good cause found'' or that the requesters were not ''persons properly and directly concerned.''[27]

The American Society of Newspaper Editors protested this approach in a report titled ''The People's Right To Know.'' It complained on behalf of the press: ''We had only the foggiest idea of whence sprang the blossoming Washington legend that agency and department heads enjoyed a sort of personal ownership of news about their units. We knew it was all wrong, but we didn't know how to start the battle of reformation.''[28] The study went on to assert as basic the ''conviction that inherent in the right to speak and the right to print was the right to know. The right to speak and the right to print, without the right to know, are pretty empty.''[29]

Against this backdrop, Congress revisited the issue of access to agency records, and in 1966 enacted what is now known as FOIA. The legislative history describes the policy that it effectuates in the following words:

> It is vital to our way of life to reach a workable balance between the right of the public to know and the need of the Government to keep information in confidence to the extent necessary without permitting indiscriminate secrecy. The right of the individual to be able to find out how his Government is operating can be just as important to him as his right to privacy and his right to confide in his Government. This bill strikes a balance considering all these interests.[30]

B. FOIA and Its Application to IRS Documents

FOIA eliminated the defenses to disclosure that had proved problematic, and it limited an agency's power to withhold records to those falling within the scope of nine carefully written and exclusive exemptions. Thus, unless one of the exemptions applies, it requires disclosure of government records without regard to either the agency's characterization of the records or its view of the wisdom of disclosure.

The exemptions that may be relevant to the disclosure of APAs and their background documents are FOIA exemptions 3, 4, 5, and 7.[31] FOIA exemption 3 permits the withholding of agency records ''specifically exempted from disclosure by statute,'' such as, for example, section 6103. FOIA exemption 4 applies to ''trade secrets and commercial or financial information obtained from a person [that is] privileged or confidential.'' FOIA exemption 5 allows the withholding of ''inter-agency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency.'' And FOIA exemption 7 applies to ''records or information compiled for law enforcement purposes,'' subject to some limitations. Even when an exemption applies, it does not necessarily permit the withholding of an

[24] 5 U.S.C. section 1002(b) and (c) (1965).
[25] S. Rep. No. 79-752.
[26] H.R. Rep. No. 89-1497.
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *See* 5 U.S.C. section 552(b)(3), (4), (5), and (7).

entire document. Rather, ''any reasonably segregable portion of a record'' must nevertheless be disclosed, ''after deletion of the portions'' to which the exemption applies.[32]

1. Litigation requiring release of letter rulings and technical advice memorandums. After the enactment of FOIA, the IRS continued its previous practice of withholding letter rulings and technical advice memorandums from disclosure. However, it was not long before this practice was challenged. In *Tax Analysts & Advocates v. IRS* (*Tax Analysts I*),[33] the publisher of *Tax Notes* sought specific letter rulings and technical advice memorandums on the basis that they constituted ''interpretations . . . adopted by the agency,'' to which FOIA applied.[34] The IRS resisted. It admitted that the documents interpreted and applied the tax law to a specific set of facts, but it made several arguments for withholding them.

First, the IRS argued that letter rulings and technical advice memorandums are not ''adopted by the agency,'' because they do not constitute ''precedent'' that agency employees are required to follow in other cases.[35] The U.S. District Court for the District of Columbia found that position to be without statutory support. It held that the words ''adopted by the agency'' reach ''any interpretation issued by the agency or its delegates acting within the scope of their authority,'' whether or not the interpretation was ever cited or relied on in another case.[36]

Second, the IRS argued that letter rulings and technical advice memorandums are not subject to disclosure, because they constitute confidential commercial or financial information falling within FOIA exemption 4.[37] The district court found that this exemption extends only to trade secrets and to information that is ''(a) commercial or financial, (b) obtained from a person, and (c) privileged or confidential.'' The court further found that the IRS had failed to adduce facts supporting its ''bare claim'' of confidentiality and that, in any event, FOIA exemption 4 would not protect an entire document, but rather ''only that information which cannot be rendered sufficiently anonymous by deletion of the filing party's name and other identifying information.''[38]

Third, the IRS argued that letter rulings can be withheld under FOIA exemption 3, which protects items specifically exempted by statute, because section 6103 provides for the confidentiality of ''returns.''[39] The district court also rejected this argument, because it found that letter rulings are not ''returns'' required to be filed, but rather are based on information voluntarily submitted to the agency.[40] In conclusion, the court adverted to the policy underlying FOIA:

> It is clear from the record herein that private letter rulings are in fact widely disseminated among the tax bar and taxpayers with similar interests and problems, and that the IRS is aware of this practice. Thus a body of ''private law'' has in fact been created which is accessible to knowledgeable tax practitioners and those able to afford their services. It is only the general public which has been denied access to the IRS's private rulings. The IRS' argument that publication would cause grave damage to its ruling system, then, is viewed by this Court as a specter having little basis in fact. Those taxpayers most likely to rely upon or challenge the rationale of letter rulings issued to others already have access to many rulings through their own efforts. Publication would simply make available to all what is now available to

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[32]5 U.S.C. section 552. FOIA provides in relevant part as follows:

> (a) (2) Each agency, in accordance with published rules, shall make available for public inspection and copying —
>
> (A) final opinions, including concurring and dissenting opinions, as well as orders, made in the adjudication of cases;
>
> (B) those statements of policy and interpretations which have been adopted by the agency and are not published in the Federal Register; . . .
>
> (C) a general index of the records referred to under subparagraph (D); . . .
>
> (b) This section does not apply to matters that are — . . .
>
> (3) specifically exempted from disclosure by statute (other than section 552(b) of this title) provided that such statute (A) requires that the matters be withheld from the public in such a manner as to leave no discretion on the issue, or (B) establishes particular criteria for withholding or refers to particular types of matters to be withheld;
>
> (4) trade secrets and commercial or financial information obtained from a person and privileged or confidential . . .
>
> (5) inter-agency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency . . .
>
> (6) records or information compiled for law enforcement purposes [subject to specified limitations] . . . .
>
> Any reasonably segregable portion of a record shall be provided to any person requesting such record after deletion of the portions which are exempt under this subsection.

[33]362 F. Supp. 1298 (D.D.C. 1973), *aff'd*, 505 F.2d 350 (D.C. Cir. 1974).

[34]362 F. Supp. at 1302 (quoting 5 U.S.C. section 552(a)(2)(B)).

[35]*Id.* at 1303.

[36]*Id.*

[37]*Id.* at 1307.

[38]*Id.*

[39]*Id.* at 1308. At the time, section 6103 protected returns, but not return information.

[40]*Id.*

> only a select few, and subject the rulings to public scrutiny as well. Such public availability and scrutiny are the very fundamental policies of the Freedom of Information Act. For, ''one fundamental principle is that secret law is an abomination.''[41]

On appeal, the D.C. Circuit affirmed the district court's opinion as it concerned letter rulings. It reversed the district court's extension of its reasoning to technical advice memorandums, however, because those memorandums were issued in response to an agency inquiry regarding filed returns and thus constituted information specifically exempted from disclosure by section 6103, as then in effect.[42]

Tax Analysts I led to a second action by Tax Analysts to gain access to all unpublished letter rulings and their background files (*Tax Analysts II*).[43] The district court granted summary judgment to Tax Analysts based on its reasoning in *Tax Analysts I* but suspended further proceedings, pending the disposition of the IRS's petition for certiorari in another case in which it had been instructed to disclose a series of rulings.[44] In the interim, the IRS proposed procedural rules to be followed in releasing letter rulings. While action in *Tax Analysts II* was suspended, and before the IRS procedural rules were finalized, Congress enacted the Tax Reform Act of 1976, which completely revamped section 6103 and enacted section 6110, thus mooting further proceedings.

2. TRA 1976's enactment of new sections 6103 and 6110. TRA 1976 completely rewrote the rules governing the confidentiality of taxpayer information and public access to unpublished positions of the IRS. Before 1976, section 6103 had provided that tax returns were public information but could be disclosed only by order of the president. Historically, that provision had been used to permit many agencies to receive copies of returns. However, after President Nixon wielded this power for political purposes, TRA 1976 turned the approach on its head; returns were classified as confidential rather than public. This protection was extended to a new category — ''return information,'' which included essentially any taxpayer-specific data, subject to the proviso known as the Haskell Amendment, which permits the release of taxpayer-specific data if it is ''in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.''[45] Congress then outlined detailed exceptions to the general confidentiality rule, preserving much of the access that had been permitted previously. Thus, while returns and return information are confidential, that confidentiality is not absolute; it can be accessed by Congress,[46] other federal agencies,[47] state and local agencies,[48] the president,[49] and even private litigants[50] under specified circumstances.

When Congress re-categorized returns as confidential and extended confidentiality to return information, it was mindful of FOIA's objectives. Thus, Congress also enacted a statutory disclosure regime in new section 6110 to ensure the disclosure of IRS working law — including working law that contains return information — while providing, through a statutory redaction process, safeguards for the confidentiality of taxpayer identities. New section 6110 provided for routine disclosure of ''written determinations'' and related background files on request, but only after redaction of information identifying the recipient, privileged or confidential trade secrets, commercial and financial information obtained from a person, and other specified information.[51]

Enactment of sections 6103 and 6110 essentially confirmed the basic holding of the district court's opinion in *Tax Analysts I*: Letter rulings, technical advice memorandums, and their background documents should be made available to the public, but a taxpayer's confidential information should be protected. The balance that Congress sought to strike is well-described in a passage from the Joint Committee on Taxation staff's general explanation of these provisions:

> Although the private rulings procedure had significant advantages for both the IRS and taxpayers, the system also contained some substantial problems. It has been argued that the private ruling system developed into a body of law known only to a few members of the tax profession. For example, an accounting or law firm with offices in Washington could have a library of all the private ruling letters issued to its clients. Such a firm was in a position to advise other clients as to the current IRS ruling position because of its special

[41] *Id.* at 1309-1310 (quoting Kenneth Culp Davis, *Administrative Law Treatise*, section 3A.12 (1970 supp.)).

[42] 505 F.2d 350, 355 (D.C. Cir. 1974).

[43] *Tax Analysts & Advocates v. IRS*, 405 F. Supp. 1065 (D.D.C. 1975).

[44] *IRS v. Fruehauf Corp.*, 429 U.S. 1085 (1977) (remanded for further proceedings consistent with the Tax Reform Act of 1976).

[45] Section 6103(b)(2).

[46] Section 6103(f).

[47] Section 6103(h), (i), (j), (k), (l).

[48] Section 6103(d).

[49] Section 6103(g).

[50] Section 6103(h)(4).

[51] Section 6110(c) through (m); reg. section 301.6110-1 to -8.

> access to these rules of law. This, in turn, tended to reduce public confidence in the tax laws. Additionally, the secrecy surrounding letter rulings generated suspicion that the tax laws were not being applied on an even-handed basis.
>
> These types of concerns led to the lawsuits described above to open private rulings to public inspection. While two courts have held private rulings to be open to public inspection, significant additional questions were raised since these court decisions. These questions concerned the parts of a ruling file that should be published, whether private rulings should be available as ''precedent'' for other taxpayers, what procedures should be established to allow taxpayers to claim that protected material should not be disclosed, etc.
>
> The Congress agrees with the previous court decisions that private rulings should be made public. Only in this way can all taxpayers be assured of access to the ruling positions of the IRS. Also, this tends to increase the public's confidence that the tax system operates fairly and in an even-handed manner with respect to all taxpayers. However, the Congress believes that the problems described above should be resolved with legislation, since the courts have not previously been given guidance by the Congress on these difficult issues in the tax field.[52]

Because section 6110 neither enumerated all forms of IRS determinations (which in any event proved a moving target) nor preempted FOIA for items not included, it did not lay to rest all questions concerning access to IRS working law. Once the new law was on the books, FOIA litigation against the IRS recommenced.

3. Litigation requiring release of general counsel memorandums, technical memorandums, and actions on decision. In *Taxation With Representation Fund v. IRS* (*TWRF*),[53] the plaintiff successfully sought three types of legal memorandums prepared by the IRS for internal use: general counsel memorandums, technical memorandums, and actions on decision. Each class of documents consisted of legal memorandums from chief counsel: General counsel memorandums generally respond to a request from the assistant commissioner (technical) for advice concerning a possible revenue ruling; technical memorandums address the preparation of proposed regulations; and actions on decision formally recommend whether to appeal an adverse decision in a particular court case.

The IRS argued that FOIA exemption 5 (inter-agency or intra-agency memorandums or letters that would not be available by law to a non-agency party in litigation with the agency) applied to these documents. The district court disagreed, finding that the documents were statements of policy explaining actions that the IRS had taken and thus constituted the working law of the agency. On appeal, the D.C. Circuit emphasized that FOIA exemptions were to be narrowly construed, but it also said that pre-decisional memorandums whose reasoning did not explain final decisions might be properly withheld under FOIA exemption 5. The court then affirmed the district court's opinion but remanded the case for consideration of whether any of the requested materials fell within this pre-decisional class. General counsel memorandums, technical memorandums, and actions on decision are now treated by the IRS as written determinations to which section 6110 applies.

4. Litigation requiring release of field service advice. The next type of IRS guidance to be brought into the light was field service advice. These documents constitute advice from attorneys in the IRS National Office to field attorneys, revenue agents, appeals officers, and others in response to requests for advice on difficult or significant tax issues. Tax Analysts sued for the release of field service advice, and the IRS resisted, making two basic arguments: first, that FOIA exemption 3 protects field service advice because it consists wholly of return information exempt from disclosure under section 6103(b)(2); and, second, that FOIA exemption 5 protects field service advice because either the deliberative process or the attorney-client privilege applies.

The district court rejected both of these defenses in *Tax Analysts v. IRS* (*Tax Analysts III*).[54] It rejected the IRS's FOIA exemption 3 argument on the basis that field service advice was similar in structure and content to the technical advice memorandums previously found to be ''written determinations'' to which section 6110 must apply. Thus, the district court directed release following redaction. The court also rejected the IRS's FOIA exemption 5

[52] *See* Joint Committee on Taxation, ''General Explanation of the Tax Reform Act of 1976,'' JCS-33-76 (Dec. 29, 1976), at 303-304 (TRA 1976 bluebook).

[53] 485 F. Supp. 263 (D.D.C. 1980), *aff'd as modified and remanded*, 646 F.2d 666 (D.C. Cir. 1981).

[54] 1996 WL 134587 (D.D.C. 1996), *Doc 96-8542*, *96 TNT 57-28*, *remanded by* 117 F.3d 607 (D.C. Cir. 1997), *Doc 97-20023*, *97 TNT 131-10*.

defense, focusing on the deliberative process privilege and emphasizing ''secret law'' concerns[55]:

> A strong theme of our deliberative process opinions has been that an agency will not be permitted to develop a body of ''secret law''. . . . FSAs, we believe, represent such a body of law. They contain the answers of the national office of the Office of Chief Counsel to legal questions submitted by IRS and Chief Counsel personnel in the field. As the IRS concedes, one of the main functions of FSAs is ''the promotion of uniformity'' throughout the country on significant questions of tax law. . . . [T]he structure and purposes of the FSA system reveal that the national office, in issuing these memoranda, is attempting to develop a body of coherent, consistent interpretations of the federal tax laws nationwide.
>
> . . . .
>
> FSAs are statements of the agency's legal position, and there is nothing premature or misleading about disclosing them. Even if an FSA reflects a view eventually rejected by a field official, it still represents the opinion of the national office of the Office of Chief Counsel, and the public can only be enlightened by knowing what the national office believes the law to be.[56]

5. Recent litigation requiring release of chief counsel advice. The most recent type of IRS guidance to be brought into the light is chief counsel advice that can be rendered in less than two hours, including e-mails containing that advice. An understanding of the seemingly bizarre temporal aspect of the latest battle in the disclosure war requires a brief explanation of Congress's action — and the IRS's reaction — following the D.C. Circuit's opinion in *Tax Analysts III*.

In the wake of *Tax Analysts III*, Congress amended section 6110 to provide that ''written determinations'' include ''Chief Counsel advice.''[57] Chief counsel advice was defined broadly in a new subsection — section 6110(i) — to include any written advice or instruction ''prepared by any national office component of . . . Chief Counsel'' and ''issued'' to the field that conveys (1) ''any legal interpretation of a revenue provision''; (2) ''any [IRS] or . . . Chief Counsel position or policy concerning a revenue provision''; or (3) ''any legal interpretation of State law, foreign law, or other Federal law relating to assessment or collection of any liability under a revenue provision.''[58]

Chief counsel reacted by taking the position that written legal advice (including advice provided by e-mail) constitutes informal advice not subject to disclosure under the new provision if that advice could be rendered in less than two hours.[59] In response, Tax Analysts sued for the release of all written chief counsel advice that had been withheld from public disclosure on the basis that the advice was capable of being rendered in less than two hours. Before the district court, the IRS argued primarily that the word ''issued,'' as used in section 6110(i)(1)(A)(i), was ambiguous and should be interpreted to allow the agency to withhold informal advice. On appeal, the IRS shifted the focus of its argument to the word ''component'' and argued that the unreviewed advice of an individual chief counsel attorney cannot constitute advice ''prepared by any national office component'' of chief counsel.

The district court in *Tax Analysts v. IRS* (*Tax Analysts IV*) granted summary judgment in favor of Tax Analysts, and the D.C. Circuit affirmed.[60] In the words of the D.C. Circuit, ''the language of section 6110 expressly and broadly requires disclosure'' of chief counsel advice.[61] ''The IRS cannot, therefore, consistent with the plain language of . . . section 6110, rely on the two-hour rule to avoid disclosing legal advice rendered in under two hours.''[62] *Tax Analysts IV* reflects the lengths to which the IRS will go in its ongoing attempt to keep portions of its working law in the dark. Fortunately, the courts continue to side with proponents of transparency.

In sum, since the enactment of FOIA, the courts have held consistently that taxpayer-specific advice

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[55]The court also considered the attorney-client privilege defense and rejected a broad application of the privilege because the confidential information communicated to the attorney writing field service advice generally concerns the taxpayer rather than the agency.

[56]*Tax Analysts III*, 1996 WL 134587 at *6-*7 (citations, punctuation, and text omitted). Tax Analysts and the IRS continued to litigate specifics concerning the release of field service advice. *See Tax Analysts v. IRS*, 1998 WL 419755 (D.D.C. 1998), *Doc 98-14275*, *98 TNT 87-15*. As Tax Analysts continued to discover other types of internal IRS documents, it continued to seek their release, and the courts continued to apply the framework described above in disposing of the cases. *See Tax Analysts v. IRS*, 2000 WL 689324 (D.D.C. 2000), *Doc 2000-10164*, *2000 TNT 67-13*.

[57]Internal Revenue Service Restructuring and Reform Act of 1998 (P.L. 105-206), section 3509(a).

[58]*Id.*, section 3509(b)(i)(l)(A).

[59]Chief Counsel Directives Manual Exh. 33.1.2-1, Q&A 12 and 13.

[60]*Tax Analysts v. IRS*, 416 F. Supp.2d 119 (D.D.C. 2006), *Doc 2006-21835*, *2006 TNT 207-7*, *aff'd*, 495 F.3d 676 (D.C. Cir. 2007), *Doc 2007-17207*, *2007 TNT 143-12*.

[61]495 F.3d at 681.

[62]*Id.*

issued by the chief counsel reveals the working law of the IRS, and as such, must be disclosed under FOIA and section 6110. The courts also have consistently held that in making those disclosures, the IRS must redact taxpayer-identifying information, trade secrets, and privileged and confidential financial and commercial information in accordance with the requirements of FOIA and section 6103. It is in this context that we analyze the anomalous treatment of APAs.

III. The Sun Also Sets

A. Birth of the APA Program

The IRS has had a long-standing policy of refusing to issue determination letters on issues that it views as ''inherently factual''[63] — a category in which the IRS historically included transfer pricing issues. In April 1990, however, it issued a draft revenue procedure for ''advance determination rulings'' in which it offered to rule on ''a proposed method under section 482 for reaching a clear reflection of income of the taxpayer and all or some of its affiliates for all or some of their inter-company transactions.''[64] The procedure envisioned that the IRS would approve a TPM for a three-year term if the critical assumptions on which the IRS relied remained valid throughout the period and if the method was applied consistently. A handful of taxpayers applied for the rulings, and the first one was issued to Apple Computer Corp. in January 1991.[65] Later that year, the IRS issued Rev. Proc. 91-22,[66] which detailed the requirements that taxpayers had to meet as well as the procedures for consideration and completion of a request. It also changed the name of the document memorializing the approved TPM from ''advance determination ruling'' to ''advance pricing agreement,'' presumably to reflect the requirement that the taxpayer assent to the determination made. By the time the APA program had been in existence for five years, taxpayers had filed 169 applications for APAs, and the IRS had completed 47 agreements, 17 of which involved a treaty partner.[67]

The issuance of an APA begins with the taxpayer's detailed application. The IRS then assigns a multidisciplinary APA team to verify the facts presented and ''to determine whether the proposed TPM constitutes the 'best method' under the Regulations.''[68] The APA team is expected to meet with the taxpayer to discuss the issues and to seek agreement on the relevant facts, the TPM, and the results. In a bilateral or multilateral case, the APA team then uses this agreement to provide a negotiating position to the U.S. competent authority for the necessary treaty negotiations. Once the competent authorities reach consensus, this agreement provides the basis for preparation of the final APA to be approved by the IRS's associate chief counsel (international) and signed by the IRS and the taxpayer. Fundamental to the process is IRS's exercise of its discretionary powers under section 482 to apply ''the arm's-length standard'' according to the relevant Treasury regulations:

> The APA Program evaluates each APA case in terms of developing *an arm's-length transfer pricing methodology that is consistent with the Regulations*. Because transfer pricing cases typically involve complex facts and difficult issues, there is room for disagreement between reasonable people, acting in good faith, about both the ''best method'' and the proper application thereof. Therefore, in evaluating and processing an APA case, APA Program Team Leaders are willing to consider taxpayer positions, to engage in negotiations, and to work to reach a mutually acceptable understanding of the appropriate application of the arm's length standard to the taxpayer's facts, *in a manner that is consistent with the Regulations*.[69]

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[63] *See, e.g.*, Rev. Proc. 89-3, 1989-1 C.B. 761, section 4.02(1).

[64] ''Full Text of Draft Revenue Procedure on Advance Pricing Rulings,'' *Tax Notes Int'l*, June 1990, p. 565 (reprinting the unpublished draft revenue procedure prepared by the IRS).

[65] John Turro, ''Transfer Pricing: Apple Computer Readies for APA Replay,'' *Tax Notes*, Aug. 10, 1992, p. 694 (noting that Apple was ''the first company to try out'' the APA program).

[66] 1991-1 C.B. 526.

[67] Announcement 2000-35, 2000-1 C.B. 922, *Doc 2000-9720*, *2000 TNT 63-11* (1999 APA annual report).

[68] *Id.* While this procedural description is drawn from the first annual report, the process remains essentially the same today. *See* Rev. Proc. 2006-9, as modified by Rev. Proc. 2008-31; *see also* Announcement 2010-21, 2010-15 IRB 551, *Doc 2010-6857*, *2010 TNT 60-10* (2009 APA annual report).

[69] Announcement 2000-35 (emphasis added). The arm's-length approach also is applied for bilateral and multilateral APAs:

> In 1995, the Organization for Economic Cooperation and Development (OECD) published transfer pricing guidelines that adopted the arm's length standard, consistent with our Section 482 regulations. Similarly, the OECD Model Tax Convention provides:
>
> > where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.
>
> Comparable language outlining the arm's length principle is included — generally in Article 9 — in most income tax treaties to which the United States is a party. Thus, in cases where competent authority negotiations aimed at relieving double taxation under the mutual

(Footnote continued on next page.)

In sum, the IRS appears to view its authority to enter into an APA as deriving from its discretionary power to apply the arm's-length standard defined in Treasury regulations promulgated under section 482.[70] As such, the IRS-approved TPMs in completed APAs constitute unpublished interpretations of the statutory and regulatory arm's-length standard that are adopted by the IRS based on the taxpayers' facts as described in their applications and other supporting documents and in the APA team's review of them. Although an APA does not usually provide the narrative explanations of authorities often provided by letter rulings, technical advice memorandums, general counsel memorandums, and field service advice, an APA serves essentially the same purpose. That is because the TPM provides an analytical or formulaic road map to the application of economic data and techniques and transfer pricing principles to the taxpayer's facts and financial information to achieve the result required by section 482. Thus, APAs do encompass the type of information that would be subject to disclosure under FOIA absent an applicable exemption.

B. The Sky Is Falling! The Sky Is Falling!

In early 1996 the Bureau of National Affairs Inc. (BNA) and Tax Analysts made unsuccessful requests for the release of APAs. BNA then sued the IRS, arguing that APAs are legally indistinguishable from letter rulings and thus constitute a private system of tax law well within the scope of FOIA.[71] Although the IRS initially fought BNA's lawsuit, it eventually conceded that APAs are subject to FOIA and announced that it would treat them as a new class of written determination subject to disclosure under section 6110.[72] Classifying APAs as section 6110 written determinations would have enabled the IRS to follow that section's well-established redaction practices rather than redacting those documents only under the direct authority of FOIA. However, the content of those redactions would have been essentially the same, because both provisions require the redaction of identifying information, trade secrets, and commercial or financial information that is privileged or confidential.[73]

Application of these well-established rules did not satisfy those who had received APAs with the expectation that they would remain secret. A group of three anonymous APA recipients protested the IRS's concession by filing an anonymous amicus brief, and the Tax Executives Institute also filed a brief defending secrecy.[74] The essential argument against disclosure was that APAs consist wholly of return information and thus both section 6103 and FOIA exemption 3 protect them from disclosure. This position ignored the fact that an APA reflects the exercise of the IRS's statutory discretion to determine an arm's-length result, FOIA's statutory preference for dealing with confidential information through redaction, and the holdings and reasoning of the opinions in *Tax Analysts I*, *II*, and *III* and *TWRF*. The practical argument against release, best encapsulated in a contemporaneous letter to Treasury's international tax counsel from a former government attorney then in private practice, ignored the plan for redaction under section 6110 and argued that any release of confidential business information would cause new applications to dry up and cause transfer pricing disputes to ''revert back to the Exam-Appeals-Tax Court cycle.'' This letter also recognized concerns about a ''secret body of law'' and proposed, as an alternative to redaction, the creation and disclosure of a sort of précis for each completed APA.[75]

In the spring of 1999 the IRS apparently followed its usual procedures under section 6110, prepared copies of completed APAs with proposed redactions, and sent them to the taxpayers for agreement or further suggested redactions. Contrary to the arguments proffered to Treasury, the IRS's January

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agreement provisions of our treaties are undertaken, the goal is a mutual agreement consistent with the OECD arm's length standard.

Id.

[70]And, in the case of bilateral and multilateral APAs, treaty provisions authorizing competent authority negotiations.

[71]*See, e.g.*, *BNA v. IRS*, 24 F. Supp.2d 90 (D.D.C. 1998); ''Publisher Files Lawsuit Demanding Release of APAs,'' *Doc 96-6013*, *96 TNT 42-8*.

[72]IR-1999-05, *supra* note 20.

[73]For trade secrets and financial and commercial information, compare section 6110(c)(4) with 5 U.S.C. section 552(b)(4) (FOIA exemption 4 to same effect). If section 6110 did not apply, the identifying information required to be redacted would still be redacted under FOIA exemption 3, 5 U.S.C. section 552(b)(3), and section 6103(b)(1) and (2).

[74]Motion for Leave to Participate as Amici Curiae, *BNA v. IRS*, No. 1:96-cv-376 (D.D.C. Feb. 28, 1999), *Doc 1999-8206, 1999 TNT 41-18* (filed on behalf of three unnamed corporations); Memorandum of Tax Executives Institute Inc. as Amicus Curiae in Opposition to Plaintiff Bureau of National Affairs Inc.'s Motion for Summary Judgment, *BNA v. IRS*, No. 1:96-cv-376 (D.D.C. Feb. 25, 1999), *Doc 1999-7965*, *1999 TNT 40-13*.

[75]Letter from Charles S. Triplett to Philip R. West, international tax counsel (Mar. 2, 1999), *Doc 1999-8380*, *1999 TNT 42-61*.

1999 announcement that disclosure would henceforth be made had no discernable impact on the flow of new applications.[76]

C. Congress Puts Out the Light

The battle to require that APAs be withheld in their entirety soon moved from the courts to Congress. There, proponents of secrecy[77] successfully argued that APAs should be defined for purposes of section 6103 as a new category of return information not subject to disclosure under FOIA or section 6110. However, the arguments made in support of this position seem neither well taken nor well supported. The central argument did not directly address the true nature of an APA; rather, it was a simple assertion that the IRS had not previously released any APAs and had previously represented that APAs and background documents were ''tax return information not subject to disclosure.''[78] Effectively, it characterized the IRS's position in *BNA* — that APAs are written determinations subject to section 6110 — as an unwarranted reversal of position. This, however, was a mischaracterization of the original IRS position, which was more nuanced:

> The information received or generated by the Service during the APA process relates directly to the potential tax liability of the taxpayer under the Internal Revenue Code. Therefore, the APA and such information are subject to the confidentiality requirements of section 6103 of the Code. The information may also be commercially sensitive and may be proprietary or otherwise privileged. Finally, the APA and such information may be confidential pursuant to the terms and conditions of income tax conventions between the United States and involved foreign governments.[79]

This statement does not meaningfully distinguish APAs from, for example, letter rulings. The history of the IRS's FOIA litigation recounted above and the reference in the passage quoted above to other bases for confidentiality indicate that the reference to section 6103 only provided comfort that any disclosure of an APA, like disclosure of other forms of taxpayer-specific guidance, would be subject to the general rules governing disclosure of material concerning specific taxpayers' circumstances. Thus, the quoted language indicated that portions of an APA would be protected from release by FOIA exemptions 3 and 4 and section 6103, just as the courts in *Tax Analysts I* and *II* had done in requiring redaction of exempt information in letter rulings. Under this reading, the IRS's concession in *BNA* that section 6110 applies would not have been a change of course, but rather only an explanation of how the mechanics of the redaction process would occur. In any event, given 20 years of experience with the redaction rules applied to letter rulings and technical advice memorandums, which seldom have proved controversial and have not impeded release of those documents, no protectable privacy interest was under serious attack.

A second argument was that the redaction process ''would be extremely difficult, burdensome, and time-consuming.''[80] This concern, which is dealt with effectively every day in the release of other legal positions and in litigation, seems hardly worth discussing when weighed against the potential development of a body of secret law — or the difficult, burdensome, and time-consuming nature of the APA application process itself.

Proponents of secrecy also argued that disclosure even in redacted form would discourage applications, largely because it might adversely affect recipients' ''ability to compete in the marketplace.''[81] The record now available leaves this assertion unsupported and unexplained. In fact, a completed APA provides a substantial competitive advantage over similarly configured competitors without APAs. Also, new applications continued unabated after the IRS's announcement that it would release redacted APAs, and those same applications were submitted before enactment of the legislation.[82] In any event, compared with the horror of a multiyear transfer pricing dispute, disclosure of a taxpayer's redacted APAs would seem to be a small consideration when deciding whether to apply for one.

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[76]Letter from BNA President Paul Wojcik to House Ways and Means Committee Chair Bill Archer (May 12, 1999), *Doc 1999-18018*, *1999 TNT 96-21* (Wojcik letter).

[77]Prominent in this group were TEI, two former IRS executives whose tax practice was focused on APAs, and the three anonymous APA recipients that had sought to intervene in *BNA*.

[78]Testimony of TEI at Ways and Means Committee oversight hearing on international tax laws (June 22, 1999), *Doc 1999-21655*, *1999 TNT 121-22* (reprinting the statement of TEI President Lester Ezrati, who was then president of Hewlett Packard Co.) (Ezrati statement); letter from Michael F. Patton and Robert E. Ackerman to Senate Finance Committee Chair William V. Roth Jr. (May 25, 1999), *Doc 1999-18089*, *1999 TNT 98-19* (Patton and Ackerman letter).

[79]Rev. Proc. 91-22, 1991-1 C.B. 526, section 11. *See also* Rev. Proc. 96-53, 1996-2 C.B. 375, section 12, *Doc 96-30384*, *96 TNT 226-8*.

[80]Ezrati statement, *supra* note 78.

[81]*Id.*; Patton and Ackerman letter, *supra* note 78.

[82]Sixty-nine applications were filed in 1999, the most of any year to date, despite the IRS's announcement in January and the fact that legislation was not enacted until December.

A final argument was that an APA was essentially an audit determination and not an instance of the IRS applying its working law to a taxpayer because, unlike a letter ruling, technical advice memorandum, or other form of taxpayer-specific guidance:

> (1) an APA is sometimes rolled back to resolve previous audits, (2) an APA often takes so long to complete that returns have been filed for some of the years under consideration by the time it is issued, (3) the APA is signed by the taxpayer as well as the IRS, (4) the APA does not include a legal analysis section, (5) the APA is so driven by facts and circumstances that the TPM essentially has no meaningful legal content, and (6) the APA results from negotiations with the taxpayer rather than the APA staff's application of transfer pricing law.[83]

Regarding arguments (1) and (2), while letter rulings are generally not issued for years under audit, this is the specific context for which technical advice memorandums are intended, and this does not alter their treatment for purposes of FOIA or sections 6103 and 6110.

Arguments (3) through (6) all appear to be different ways of arguing that an APA is not really an application of the IRS's view of legal principles to the taxpayer's facts. Although an agency's secret law is generally subject to disclosure under FOIA, its enforcement decisions are not. Thus, FOIA normally would require the release of the legal content of an APA if it constitutes advance guidance but would treat the APA as exempt if its essence is the negotiated resolution of an audit. The FOIA exemption from disclosure that would presumably apply is exemption 7 (records or information compiled for law enforcement purposes).[84] This distinction has been used as a supporting argument for the confidentiality of APAs and is probably the reason for a line of rhetoric by the IRS and others characterizing APAs as mechanisms for alternative dispute resolution.[85]

Another distinction between advance guidance and dispute resolution that may be appealing to defenders of secrecy is that, while consistency and the reconciliation of divergent positions are essential values for legal determinations, inconsistent results in the resolution of disputes often can be justified as the exercise of prosecutorial discretion.[86] Whether applicants in the APA program receive consistent treatment and whether the IRS is applying in litigation the same law that it applies in its ruling programs has little importance if the APA context is analogous to a prosecutor's choosing which cases to try and which cases to settle or not pursue while obtaining whatever concessions he can within his overall resource constraints. Put another way, ''settlement discretion . . . is at its heart a discretion to treat similarly situated taxpayers differently,''[87] while a legal determination — particularly one that turns on the exercise of statutory discretion — would be an abuse of discretion ''if it were made without a rational explanation, inexplicably departed from established policies, or rested on an impermissible basis.''[88]

The problem with applying settlement disclosure rules to APAs is not that the principles governing settlements are wrong; it is simply that they do not apply to APAs. The essence of an APA is that, as the name suggests, it deals with proper prospective pricing. If a case involves only the resolution of tax years already filed and under audit when the application was filed, the IRS will not accept the application.[89] Further, in the *BNA* litigation, the IRS formally admitted that ''an Advance Pricing Agreement does *not* compromise any claim by the IRS to tax revenue.''[90] Indeed, before the 1999 expansion of ''return information'' to include APAs, the IRS publicly agreed that APAs ''fall under the disclosure provisions of IRC section 6110.''[91] That provision applies only to ''written determinations,'' which at the time were defined as ''a ruling, determination

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[83]Patton and Ackerman letter, *supra* note 78.

[84]5 U.S.C. section 552(b)(7).

[85]*See, e.g.*, H.R. Rep. 106-344, at 20 (''The Advance Pricing Agreement . . . program is an alternative dispute resolution program conducted by the IRS, which resolves international transfer pricing issues prior to the filing of the corporate tax return''); Steven C. Wrappe, ''Advance Pricing Agreements: The IRS Rediscovers Alternative Dispute Resolution,'' *Tax Notes*, June 6, 1994, p. 1343, *94 TNT 112-29* (at the time he wrote the article, Wrappe was an attorney on the APA program staff).

[86]Thus, for example, in resolving a case before it, the Tax Court will not look to how the IRS selected an unrelated case for audit or settled or litigated it unless the taxpayer in the pending case can establish that the difference in treatment by the IRS was based on ''impermissible considerations such as race, religion, or the desire to prevent the exercise of constitutional rights.'' *Penn-Field Indus. Inc. v. Commissioner*, 74 T.C. 720, 723 (1980).

[87]*Bunce v. United States*, 28 Fed. Cl. 500, 509 (1993), *aff'd without published opinion*, 26 F.3d 138 (Fed. Cir. 1994).

[88]*Estate of Gardner v. Commissioner*, 82 T.C. 989, 1000-1001 (1984) (citation omitted); *see also United States v. Kaiser*, 363 U.S. 299, 308 (1960) (''The Commissioner cannot tax one and not tax another without some rational basis for the difference.'') (Frankfurter, J., concurring); *Sirbo Holdings Inc. v. Commissioner*, 476 F.2d 981, 987 (2d Cir. 1973) (Friendly, J.); *Int'l Business Machines Inc. v. Commissioner*, 343 F.2d 914 (Ct. Cl. 1965).

[89]Rev. Proc. 91-22, section 1; Rev. Proc. 2006-9, section 2.01.

[90]Defendants' Responses to Plaintiff's First Set of Requests for Admissions, at 10, *BNA v. IRS*, No. 1:96-cv-376 (D.D.C. 1996).

[91]IR-1999-05, *supra* note 20.

letter, technical advice memorandum, or chief counsel advice.''[92] The tax law is replete with cases that acknowledge the relevance of written determinations or cite them as evidence of IRS administrative practice for purposes of considering the extent of the commissioner's duty of consistency in areas in which statutory discretion is relevant.[93]

Although arguments in support of disclosure were substantial,[94] no constituency aggressively defended them. On December 17, 1999, Congress enacted section 521 of the Ticket to Work and Work Incentives Improvement Act of 1999, which amended section 6103 to describe APAs and their background documents as ''return information'' and amended section 6110 to exclude them from the definition of written determinations.[95] Although the legislative history asserts, without meaningful discussion, that the APA program is an alternative dispute resolution program rather than something akin to a ruling program, it seems to acknowledge that this position is doubtful by enacting the annual report requirement to ameliorate the secret law problem:

> Congress must balance the need for confidentiality with the general public's need for practical tax guidance. Some members of the public have expressed concern that the APA program has led to the development of a body of ''secret law,'' known only to a few members of the tax profession. In addition, some members of the public contend that taxpayers have received APAs permitting the use of transfer pricing methodologies not contemplated in the section 482 regulations. They also contend that APAs have provided interpretations of law not available to taxpayers that do not participate in the APA process. Such concerns could undermine the public's confidence in the IRS's ability to fairly enforce the transfer pricing rules. Thus, the provision requires the Department of the Treasury to prepare and publish an annual report regarding APAs, which will provide extensive information regarding the program while clarifying that existing and future APAs and related background information continue to be confidential return information.[96]

The off-code provision requiring an annual report lists the required elements for the report. Many involve only statistical information, but some contemplate the disclosure of substantive information. The statute provides that the report must include ''methodologies used to evaluate tested parties and transactions and the circumstances leading to the use of those methodologies'' as well as a variety of other information.[97] Indeed, it is difficult to read the foregoing legislative history and the statutory list of required elements without concluding that Congress intended the report to include meaningful disclosure of the working law applied in the APA program.[98] Further, Congress specifically delegated to Treasury discretionary authority to go beyond the required elements for the report. Thus, the statute permits Treasury, if it wishes, to disclose detailed information about the individual APAs approved, because the only constraint on this sort of disclosure is that the report:

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[92]Section 6110(b)(1) (1998).

[93]*See, e.g.*, *Oshkosh Truck Corp. v. United States*, 123 F.3d 1477, 1481 (Fed. Cir. 1997); *Tax Analysts v. IRS*, 117 F.3d at 614 (''If the Office of Chief Counsel renders an interpretation of a certain section of the tax code, whether in an FSA or elsewhere, that interpretation should apply to all other taxpayers who are, in material respects, similarly situated. Treating like cases alike is, we have said, 'the most basic principle of jurisprudence.'").

[94]Many are encapsulated in the Wojcik letter, *supra* note 76.

[95]Ticket to Work Act, section 521(a).

[96]H.R. Rep. 106-344, at 21-22 (1999).

[97]Ticket to Work Act, section 521(b)(2)(D). The full list reads as follows:

> (D) General descriptions of —
> (i) the nature of the relationships between the related organizations, trades, or businesses covered by advance pricing agreements;
> (ii) the covered transactions and the business functions performed and risks assumed by such organizations, trades, or businesses;
> (iii) the related organizations, trades, or businesses whose prices or results are tested to determine compliance with transfer pricing methodologies prescribed in advance pricing agreements;
> (iv) methodologies used to evaluate tested parties and transactions and the circumstances leading to the use of those methodologies;
> (v) critical assumptions made and sources of comparables used;
> (vi) comparable selection criteria and the rationale used in determining such criteria;
> (vii) the nature of adjustments to comparables or tested parties;
> (viii) the nature of any ranges agreed to, including information regarding when no range was used and why, when interquartile ranges were used, and when there was a statistical narrowing of the comparables;
> (ix) adjustment mechanisms provided to rectify results that fall outside of the agreed upon advance pricing agreement range;
> (x) the various term lengths for advance pricing agreements, including rollback years, and the number of advance pricing agreements with each such term length;
> (xi) the nature of documentation required; and
> (xii) approaches for sharing of currency or other risks.

[98]An early version of the legislation was even more directive, requiring that it include ''the summary of the methodology used in each such agreement and a hypothetical illustration of the methodology's operation.'' H.R. 2378, section 2(a)(2)(F).

shall not include information —

> (A) which would not be permitted to be disclosed under section 6110(c) . . . if such report were a written determination as defined in section 6110 of the Code; or
>
> (B) which can be associated with, or otherwise identify, directly or indirectly, a particular taxpayer.[99]

Treasury could interpret the foregoing statute to permit the disclosure, in summarized fashion, of the essential working law applied in the agreements, just as it has used letter rulings as a source for published revenue rulings for many decades.

IV. Nightfall — APA Annual Reports

Those who had hoped that the IRS's annual reports would strike a balance between the confidentiality of taxpayer-specific information and disclosure of the working law applied were doomed to disappointment. The first annual report — and every report issued thereafter — is akin to an auto manufacturer's catalogue, providing no pictures or descriptions of the various models sold, but rather enumerating the aggregate number of carburetors, pistons, axles, bolts, body panels, and other parts used during the year, and leaving to the reader's imagination which parts were used for each model and how they were assembled. Each report treats the elements required by the statute as the only items to be dealt with, tabulates them in isolation from one another, and practically ignores Congress's invitation to provide further information. In effect, the IRS's longstanding practice of protecting secret law — evident from its decades of unsuccessful FOIA litigation — continues.

A comparison of the statutory requirements and the information provided in the reports is instructive. Much of each report covers administrative matters (16 out of the 36 pages in the 2010 report): the staffing and organization of the APA office and statistics concerning the number of APAs issued and completion times. The balance deals with required information concerning APAs issued during the reporting year, but the coverage is essentially limited to the IRS's narrow interpretation of the information required by section 521(b)(2)(D) of the Ticket to Work Act.

Clause (i) of that section requires a general description of ''the nature of the relationships between the related organizations, trades, or businesses covered.'' The only information the IRS discloses in response is a numerical table showing the industries in which APAs were issued and a separate table showing the number of APAs in which the applicant was a foreign parent with one or more U.S. subsidiaries, a U.S. parent with one or more foreign subsidiaries, or a partnership. No narrative description is provided for either of these tables. In essence, the IRS discloses nothing of interest from a substantive standpoint.

Clause (ii) requires general descriptions of ''the covered transactions and the business functions performed and risks assumed by such organizations, trades, or businesses covered by advance pricing agreements.'' The report includes four tables in response to this directive. The first table provides the number of covered transactions involving the sale of property, the use of intangible property, the performance of services, or cost sharing. Transactions into and from the United States are tabulated separately. The second table lists the different categories of services included in covered transactions. The third table lists functions performed by tested parties, and the fourth table lists risks assumed by tested parties. A brief narrative follows. It discloses that any given covered transaction may involve many of the functions and risks disclosed in the tables, and it makes the point that the APA program staff spends a substantial portion of its time performing a functional analysis that ''goes beyond simply categorizing the tested party as, say, a distributor.'' However, nothing in the narrative provides anything like a ''general description'' of a covered transaction. Nor are any of the tables cross-tabulated with any other table. One can reasonably distill these tables and the accompanying narrative as an assertion that each covered transaction must be analyzed individually, and that when the analysis is completed, each transaction is unique and hence no general description is warranted or indeed possible.

Clause (iii) of the statute requires a general description of ''the related organizations, trades, or businesses whose prices or results are tested to determine compliance with transfer pricing methodologies prescribed in advance pricing agreements.'' All that is provided is a table of the types of organizations whose prices are tested. For example, in 2009 the prices or results of 31 ''distributors'' were tested. Nothing further is disclosed; there is no information concerning the North American Industry Classification System (NAICS) codes of the distributors, the extent to which they performed the functions or incurred the risks listed in the tables provided under clause (ii), nor anything else other than whether they were categorized as ''U.S.'' or as ''foreign.'' This simplistic characterization of a business as ''distributor,'' ''manufacturer,'' ''provider of

[99]Ticket to Work Act, section 521(b)(3).

services,'' ''licensor of intangible property,'' or ''participant in cost sharing agreement'' is about as general as a description can get.

Clause (iv) requires a general description of the ''methodologies used to evaluate tested parties and transactions and the circumstances leading to the use of those methodologies.'' This portion of the report provides two tables — one for the TPMs used for transfers of tangible and intangible property and one for the TPMs used for services — and a page and a quarter of so-called discussion. The descriptions of the methods amount to brief phrases, such as ''CPM: PLI is operating margin.'' The ''discussion'' essentially explains that, in choosing a method, APA program personnel apply the regulations. The reports provide little of substance beyond that platitude.

The other categories of information required by the statute are similarly treated. Whether dealing with critical assumptions, comparable selection criteria and the rationale used in determining that criteria, the nature of adjustments to comparable or tested parties, the nature of ranges, adjustment mechanisms, term lengths, documentation, or currency risks, the report treats each category of information in isolation. It provides a brief numerical table listing the number of times a particular characteristic of the category occurred. It also completes the category with a brief narrative discussion that, with minor exceptions, studiously avoids any insight into how each category is related to the other categories or to particular types of transactions. The greatest level of information is provided when the report deals with the technical details of comparables selection and adjustment. In general, the narrative language of each year's report repeats verbatim the text of the second report (issued in 2001), with changes made only to reflect different coverage from year to year.

V. All Hope Abandon, Ye Who Enter Here

A. The Limited Role of APAs

The IRS describes the APA program as an alternative way of administering the law. The first annual report makes this explicit:

> The Advance Pricing Agreement Program is designed to resolve actual or potential transfer pricing disputes in a principled, cooperative manner, as an alternative to the traditional adversarial process.[100]

This contrast between ''principled'' case resolution and the ''traditional adversarial approach'' is unfair, at least in terms of how the audit process should proceed. But the contrast drawn is not inadvertent, because the report goes on to tout the use of multifunctional APA teams that draw on the IRS Large and Midsize Business Division,[101] an international examiner, field counsel, and, if appropriate, IRS Appeals to avoid the problems of the audit process:

> The multi-functional nature of APA teams combines the APA Program's transfer pricing expertise and APA experience with other elements of the IRS that possess complementary or supplementary knowledge about the taxpayer, the taxpayer's industry, related or ancillary tax issues, the foreign competent authority, and other relevant issues. By bringing all relevant parties to the table in a single proceeding, *the APA process is able to resolve transfer pricing issues early on in a more principled, efficient, consistent, and comprehensive manner than the standard administrative process (i.e., audit, appeals, litigation)*.[102]

Although the goals expressed are laudable, they implicitly accept the proposition that the audit, appeals, and litigation process may be less principled and consistent than is warranted.

At one time, it seemed likely that the more principled and consistent approaches of the APA program would find their way into the general audit, appeals, and litigation processes. Thus, the first report stated that the ''analysis of real-life cases . . . can enable the IRS to provide better and more timely guidance,'' and it cited Notice 94-40[103] as an example of the ''synergy between the APA Program and issuance of general guidance.'' Notice 94-40 is the distillation of global-dealing APAs. It provides a method for some institutions that trade securities on a 24-hour basis, passing the book of positions from location to location as the business day moves around the globe. Further, the APA program has over the years organized teams to handle specific industries that have used APAs heavily, in the belief that the teams would ''develop a more sophisticated understanding'' of issues.[104] Thus, there are specialized teams for cost-sharing

[100]1999 APA annual report, *supra* note 67 (''Background'' section).

[101]Effective October 1, 2010, as part of a realignment designed to increase international tax compliance, the LMSB was renamed the Large Business and International Division. For purposes of this report, we will continue to refer to the division as it historically has been known, the LMSB.

[102]1999 APA annual report, *supra* note 67 (section titled ''The APA Process'') (emphasis added).

[103]1994-1 C.B. 351, *Doc 94-3816*, *94 TNT 70-12*.

[104]*See, e.g.*, 1999 APA annual report, *supra* note 67, at 9.

Table 1. New APAs Entered Into												
Year Signed	1991-1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Total
APAs	195	63	55	85	58	65	53	82	81	68	63	—
Less Renewals	—	-21	-16	-21	-17	-21	-16	-35	-29	-24	-28	—
Unique APAs	195	42	39	64	41	44	37	47	52	44	35	640
APAs Per Year	34 (over 19 years)											
Source: IRS APA Program Annual Reports, Table 1 (2001-2010) and Table 2 (2000).												

arrangements, financial products, the semiconductor industry, the automotive industry, and the pharmaceutical industry.[105] If those teams have developed a common approach and more sophisticated understanding, however, it has not made its way out of the APA program. Sixteen years later, Notice 94-40 is not just one example of the synergy possible between the APA program and the general guidance program; it remains the only example, despite the IRS's promise in 1994 to continue issuing this guidance as it continued to issue APAs.[106] Far from becoming an engine for general improvement in the IRS's administrative approach to transfer pricing cases, the APA program appears to have become an island unto itself.

This isolation is particularly disappointing because, if lessons learned in the APA program do not affect the larger world of transfer pricing problems, the program is probably not worth keeping. A review of Table 1 in the annual reports shows that the APA program has resolved very few cases. While it presumably works well for those who get APAs, that is not a large group of taxpayers. In aggregate numbers, over the term of the program the output has been no more than 35 completely new agreements each year (45 per year since 1999).

If one reconciles these numbers with the average six-year term of an APA[107] and includes renewals, the indication is that only about 400 APAs are in effect at any one time. Further, these 400 APAs are substantially greater than the number of taxpayers who have APAs in effect, since it is common for recipients of bilateral APAs and taxpayers operating in more than one foreign country to receive more than one APA. Also, of course, renewal APAs cover continuing transactions for which the taxpayer has already received an APA.[108] The spotty coverage of the APA program is made somewhat clearer when this data is considered according to NAICS codes. Table 2, appended to the end of this report, shows that for the period 2001 to 2009, two-thirds of the issued agreements occurred in just seven NAICS three-digit codes, and that for most of the others, seldom was more than one APA completed in any one year.[109]

Because the frequency with which multiple APAs are issued to a single taxpayer is not disclosed, one cannot say with certainty how many different taxpayers have received APAs or what percentage they represent of all taxpayers that have significant transfer pricing issues, but the number and percentage must be fairly small. One can get a feel for the magnitude from data collected by IRS Statistics of Income division on the NAICS codes of corporate taxpayers reporting subpart F income from controlled foreign corporations. While the overlap is imperfect, it shows, for example, that in 2006 more than 11,000 taxpayers with controlled foreign subsidiaries conducted business within the industries in which APAs have been issued.[110] Making the overly generous assumption that this number did not grow and that each of the APAs issued in 2009 was issued to a unique taxpayer (and ignoring that many APAs would have been issued to foreign taxpayers conducting business through U.S. subsidiaries), the 35 new APAs issued in 2009 amounted to less than three-tenths of 1 percent of

[105]Despite the formation of teams along these lines, the APA annual reports lump pharmaceutical APAs together with APAs issued to all companies involved with "chemicals and related products" for purposes of its industry statistics.

[106]*See* FS-94-5 (Apr. 1994), *Doc 94-3817, 94 TNT 70-13* ("The IRS promised that as it developed APA experience with various taxpayers in a particular industry, it would publish a notice describing in general terms the methods and factors used to allocate income. Notice 94-40 . . . is the first of those notices.").

[107]2009 APA Annual Report, *supra* note 68, at Table 28.

[108]In fact, the APA revenue procedure specifically contemplates this by providing a quantity discount for a taxpayer seeking more than one APA. *See* Rev. Proc. 2004-40, 2004-2 C.B. 50, section 4.12(f), *Doc 2004-13677, 2004 TNT 128-9*, superseded by Rev. Proc. 2006-9.

[109]This table is drawn from Table 1 in the annual reports issued in 2002 through 2010 for the program years 2001 through 2009. Pre-2001 years are excluded because the IRS put the charts for those years together somewhat differently. It is impossible to arrive at precise numbers because of the IRS practice of reporting a range of one to three APAs entered into when the actual number for the particular category is three or fewer.

[110]These statistics are available on the IRS's website for tax statistics, produced by the SOI division of the IRS. *See* http://www.irs.gov/taxstats/bustaxstats/article/0,,id=96282,00.html.

the taxpayers that likely would have transfer pricing issues. This spotty coverage reflects both the APA program's resource limitations[111] and the choice of most taxpayers not to seek APAs. Doubtless there are many reasons for this, among which must be taxpayers' unwillingness to seek APAs for transfer pricing practices that they think the IRS might view as controversial, complex, or aggressive. But one additional factor is likely the general unavailability of meaningful information concerning the working law that the APA program applies to concrete problems as well as the outcomes that result. The most salient fact remains, however, that nearly every taxpayer with transfer pricing issues must now deal with them through ''the traditional adversarial process.''[112]

B. How the Adversarial Process Differs

It seems likely that there is a substantial disparity between transfer pricing law as applied in the APA program and transfer pricing law as applied by IRS personnel in an audit context. Indeed, any taxpayer representative who accepted in an APA context the positions that the IRS takes in audits and litigation would be committing professional suicide. While the crucible of the APA program was the IRS's expenditure of vast resources in unsuccessful transfer pricing litigation, the IRS's use of section 6103 to block any substantive information concerning the law applied in the APA program leaves transfer pricing audits and controversies to occur in a counter-world in which the IRS's exercise of discretion bears little resemblance to what presumably occurs when entering into APAs.

Over the last 30 years, the typical litigated transfer pricing case has involved a business in which valuable non-routine intangible rights are used by a U.S. or foreign affiliate or both. The non-routine intangible may be, for example, a drug patent,[113] an industrial patent,[114] a trademark,[115] copyrighted software,[116] or expertise reflected in valuable trade secrets.[117] Either the foreign party or the U.S. party may have created or acquired the intangible.[118] Once created or acquired, the two parties may have shared the risks and costs of further development and marketing, or they may have been borne primarily or exclusively by one party or the other.[119] At the beginning of the contested period, the intangible may have been newly created, or it may be in the middle or toward the end of its useful life.[120] Its transfer may have been the subject of a formal contract, such as a contract of sale, a license, or a cost-sharing agreement, or there may be no formal agreement.[121] Whatever the basic underlying facts, the IRS's position in litigated cases has been consistent over the last 30 years: All of the intangible profit belongs to the U.S. party, and none of it belongs to the foreign party, which is essentially entitled only to a routine return on its tangible assets and current costs. Proposed adjustments reflect this position by treating the U.S. party as the real owner of the intangibles,[122] by requiring the U.S. party to pay only a minimal royalty in exchange for the use of the intangible (regardless of its commercial value),[123] by ignoring financial risks taken and contractual rights and obligations acquired or assumed by the foreign party,[124] or through some other theory.[125]

Litigating this type of case is extraordinarily costly and time-consuming for the taxpayer, the IRS, and the courts for many reasons: (1) the arm's-length standard asks a fundamentally hypothetical and counterfactual question (What would have happened if the parties had not been related?); (2) the taxpayer's burden is heavy because the court

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[111]Craig Sharon, former director of the APA program, recently commented that understaffing — particularly of economists — is contributing to significant delays and that as a result, new submissions are having to wait between four and six months to be processed. *See* Molly Moses, ''IRS Completes 23 APAs in First Half of 2010; Inventory Reaches 378 Cases,'' 19 *Tax Mgmt Transfer Pricing Report* 460 (2010).

[112]It remains to be seen whether the IRS's recent imposition of a requirement that taxpayers file a schedule disclosing uncertain tax positions, see, *e.g.*, Announcement 2010-75, 2010-41 IRB 428, *Doc 2010-20922*, *2010 TNT 186-26*, will result in more taxpayers seeking APAs.

[113]*See Eli Lilly & Co. v. Commissioner*, 84 T.C. 996 (1985), *aff'd in part, reversed and remanded in part*, 856 F.2d 855 (7th Cir. 1988); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987).

[114]*Bausch & Lomb Inc. v. Commissioner*, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1990).

[115]*DHL Corp. v. Commissioner*, T.C. Memo. 1998-461, *Doc 99-739*, *98 TNT 251-12*, *aff'd in part, reversed and remanded in part*, 285 F.3d 1210 (9th Cir. 2002), *Doc 2002-8946*, *2002 TNT 72-9*.

[116]*Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *Doc 2009-27116*, *2009 TNT 236-17*.

[117]*Hospital Corp. of America v. Commissioner*, 81 T.C. 520 (1983).

[118]For this position by the IRS when the intangibles were created outside the United States, see *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172 (1985).

[119]*Compare DHL*, T.C. Memo. 1998-461 (shared development and marketing), *with Ciba-Geigy*, 85 T.C. 172 (licensee bore costs of further development and marketing).

[120]*Compare Veritas*, 133 T.C. 297 (newly created), *with Eli Lilly*, 84 T.C. 996 (midstream transfer and expired patent).

[121]*E.g., compare DHL*, T.C. Memo. 1998-461 (trademark not licensed), *with Eli Lilly*, 84 T.C. 996 (formal license).

[122]*E.g., Ciba-Geigy*, 85 T.C. 172.

[123]*Id.*

[124]*Veritas*, 133 T.C. 297.

[125]This is not meant to imply that the taxpayer's position is always right or even reasonable.

must defer to the commissioner's exercise of administrative discretion unless adequately rebutted; and (3) establishing that the taxpayer made the economically correct division of profit can require extensive expert testimony and admissible evidence of all the significant events leading to the profits in question. Thus, the taxpayer may have to establish a detailed record concerning the creation and ownership of intangibles with their roots in the distant past, the projected profitability (and thus value) of those intangibles at various times, the risks and costs assumed by each party, and the economic and industry context in which events occurred. In some cases, essential facts may have occurred decades earlier, and key witnesses may be hostile, aging, failing, or worse.[126] In sum, this type of case effectively may require, at great cost, the telling and economic interpretation of an extended corporate history, often ill-preserved by the business executives involved and of no continuing interest to anyone but for the pending tax case.

The IRS's notice-of-deficiency position in transfer pricing cases is seldom sustained. Frequently, it is not even seriously defended by the IRS's own counsel. Sometimes when the audit position fails to follow the auditor's intangibles position to its extreme but logical conclusion, IRS counsel increases the proposed deficiency.[127] In other cases, IRS counsel and their economic experts find the notice of deficiency's allocation to the U.S. affiliate indefensible, and they concede a substantial portion of the deficiency before trial.[128] Whichever litigation strategy is pursued, the court generally rejects as arbitrary and capricious the IRS's exercise of its discretion to determine an arm's-length result, and the IRS seldom succeeds in sustaining as much as half the amount ultimately pursued. Even when a portion of the deficiency is sustained, the courts consistently reject IRS attempts to sweep all intangible profits back to the United States. Generally, the foreign affiliate is found to have a substantial interest in the contested intangibles or some other sound basis for attracting a substantial portion of the non-routine return, and the IRS's position is substantially defeated.[129]

The most recent example is *Veritas Software Corp. v. Commissioner*.[130] That case addressed the buy-in payment due to the taxpayer, Veritas US, from its Irish affiliate, Veritas Ireland, when the two companies entered into a cost-sharing arrangement. Under that arrangement, Veritas Ireland acquired the right to exploit, and the obligation to share in the costs of, future generations of software for European and other specified markets. The IRS's notice of deficiency asserted that the correct buy-in payment was $2.5 billion rather than the $118 million that Veritas Ireland had actually paid. During the pretrial period, the IRS trial team reduced this assertion by $825 million, to $1.675 billion. This remaining amount, converted to a royalty based on the IRS's assumptions, would have required Veritas Ireland ''to allocate a buy-in payment equal to 100 percent of its actual and projected operating income to Veritas US through 2009, resulting in $1.9 billion in losses over that period.''[131] The Tax Court found that the IRS's revised position was based on several unsupportable assumptions, including the assumption that short-lived software would have a perpetual life, the application of excessive assumed growth rates, underestimation of the proper discount rate for future cash flows, failure to segregate the specific intangibles to which the required payment was attributable from other valuable aspects of the business, and a failure to acknowledge Veritas Ireland's independent contributions to its share of the business. The court then adopted, with some changes, the method put forth by the taxpayer, which assumed that the technology transferred had only a four-year life and became progressively less valuable over that period. That method also assumed that revenues would grow at a much slower rate than IRS assumptions and that the economically correct financial discount rate was much higher. In short, the IRS's notice-of-deficiency position, even as reduced on the eve of trial, was roundly rejected because it failed to reflect fundamental facts concerning the taxpayer's business and finances.

The IRS's position in *Veritas* is in many ways unchanged from its position 25 years earlier in cases such as *Eli Lilly & Co. v. Commissioner*.[132] In that case, the IRS asserted that essentially all profits attributable to non-routine intangibles acquired by a foreign affiliate from its U.S. parent in a section 351 transaction had to be reallocated to the U.S. parent. The U.S. parent (Lilly) had transferred its patent rights to popular drugs to a Puerto Rico

[126]This circumstance has led to a joint application for early depositions to preserve the testimony of key witnesses. *See GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, 117 T.C. 1 (2001), *Doc 2001-18519*, *2001 TNT 130-9*.

[127]*See Ciba-Geigy*, 85 T.C. at 174-175.

[128]*See Veritas*, 133 T.C. at 311-312.

[129]*Id.*; *see also DHL*, T.C. Memo. 1998-461.

[130]133 T.C. 297. Although the IRS did not appeal the Tax Court's decision in *Veritas*, on November 10, 2010, it released an action on decision announcing that it would not acquiesce in the result or the reasoning of the Tax Court's decision. *See* AOD 2010-05, *Doc 2010-24215*, *2010 TNT 218-15*.

(Footnote continued in next column.)

[131]133 T.C. at 326-327.

[132]84 T.C. 996. *See also Bausch & Lomb*, 92 T.C. 525; *G.D. Searle*, 88 T.C. 252; *Ciba-Geigy*, 85 T.C. at 172.

affiliate (PR). Thereafter, PR manufactured the drugs, but Lilly continued to market and distribute the products in the United States. In litigation, the IRS permitted PR only a contract manufacturer's return. The Tax Court rejected the IRS's position that its discretionary power extended to disregarding the transfer of valuable intangibles to PR or limiting PR to a routine return on costs and location savings.[133] The court went on to recognize PR's entitlement to a return on intangibles and to provide Lilly the return appropriate to its research and development, sales, and marketing functions.[134]

Although *Veritas* and *Eli Lilly* were decided 25 years apart and differ substantively in many respects, the IRS's perspective in these cases — that a foreign affiliate of a U.S. taxpayer should not be permitted to retain non-routine returns from valuable intangible assets that it has the contractual right to exploit — has been a consistent theme during the intervening period. This theme has been consistently rejected by the courts.[135]

The only public evidence explicitly confirming the disconnect between outcomes in the APA program and IRS litigating positions came to light during the transfer pricing litigation filed by GlaxoSmithKline Holdings (Americas) Inc. (Glaxo US) in the Tax Court.[136] The Glaxo case involved a dispute over the division of profits from the drug Zantac between the foreign R&D and manufacturing facilities of the British parent (Glaxo UK) (where the drug had been invented and manufactured) and its affiliated U.S. distributor, Glaxo US, which had been formed to market and distribute the product in the United States. As in other, non-pharmaceutical cases, the IRS sought to treat the U.S.-based activities of Glaxo US as attracting most of the intangible returns for the product, even though those activities were essentially the marketing and selling activities normally used to promote any patented drug.

Uniquely in this case, an APA involving a similar drug and a similar division of functions and risks existed and was available to the taxpayer. Zantac, which treated peptic ulcers, replaced a competing drug, Tagamet, as the largest selling drug in the world during the tax years in dispute, and Tagamet's U.S. distributor had sought and obtained an APA. Like Zantac, Tagamet had been discovered and developed by a U.K. drug company (in Tagamet's case, SmithKline Beecham (SKB)), and was promoted by a U.S. affiliate (SKB's subsidiary, SB Corp.). Hence, the basic facts concerning discovery, development, and promotion were similar. SB Corp.'s APA determined the arm's-length fee attributable to its promotion of Tagamet. Because the drugs treated the same diseases in the same way, were both discovered and developed in the United Kingdom, were promoted in direct competition with each other using similar sales techniques, and had similar success, there was a strong basis for believing that the main difference between the two cases from a transfer pricing perspective was that SB Corp. had received an APA while Glaxo US had not.[137]

A comparison of the SB Corp. APA and the pleadings in the Glaxo case is disquieting for anyone who thinks that examining agents and APA program personnel should apply the same working law to the taxpayers that they serve. The Tagamet APA tests the return of the U.S. distributor, applying a resale price method that required the U.S.

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[133]*See also Hospital Corp. of America*, 81 T.C. 520 (finding (1) that Hospital Corp. of America (HCA)'s organization of its foreign subsidiaries was a natural division of HCA's use of Cayman subsidiaries to perform management contracts with a newly formed Saudi Arabian hospital and fit within its general philosophy of decentralized management, local identity, and local authority; (2) that the use of a subsidiary to assign responsibility and to keep separate accounting was a business purpose; and (3) that despite the minimal functions performed by the subsidiary, it was entitled to retain 25 percent of its income).

[134]A substantial portion of the Tax Court's reallocation was attributable to Judge Darrell D. Wiles's view that Lilly at arm's length would have required PR to pay Lilly's unrelated research costs in cash. This legal reasoning was reversed on appeal, although the Seventh Circuit did not disturb the deficiency found by the Tax Court.

[135]*See, e.g.*, *Bausch & Lomb*, 92 T.C. 525; *Sundstrand Corp. v. Commissioner*, 96 T.C. 226 (1991), and cases cited, *supra*, text accompanying notes 113 to 135.

[136]Richard Stark and Hartman Blanchard participated in the representation of Glaxo US in this case.

[137]Shortly after the IRS began the APA program, Tagamet's distributor, SmithKline Beecham Corp (SB Corp.) sought and received an APA defining the profit required to be reported in the United States. After its transfer pricing audit had commenced, Glaxo US unsuccessfully sought a similar APA. Glaxo UK obtained access to the Tagamet APA when it merged with SB Corp. in 2000, and in the Zantac transfer pricing litigation Glaxo US asserted that the Tagamet APA was relevant to the question of whether the IRS had improperly treated two direct competitors unequally. With the APA thus placed in issue, the IRS publicly disclosed it in court filings during the course of the litigation. Thus, this APA and the IRS's trial position in the Zantac litigation demonstrate the different approaches that can be taken by IRS examining agents and APA program personnel when faced with fact patterns having substantial similarities. Glaxo used the same transfer pricing economist as SB Corp., and that economist filed an affidavit in the course of proceedings stating that his fact investigations led him to conclude that the transfer pricing characteristics of the two U.S. subsidiaries' efforts were comparable. The similarities are described in detail in Petitioner's Memorandum in Opposition to Respondent's Motion for Partial Summary Judgment, *GlaxoSmithKline Holdings (Americas) Inc. v. Commissioner*, Tax Court Dkt. No. 5750-04 (Feb. 22, 2005), *Doc 2005-3635*, *2005 TNT 36-15*.

promoter, SB Corp., to earn a ''marketing commission'' of approximately 36 percent of sales, to be used to cover its promotional costs and realize a profit, with the remaining approximately 64 percent of sales flowing back to the patent owner and manufacturer in respect of patent rights and manufacturing risks and functions. Although Glaxo US adopted a similar resale price method in its section 6662 documentation,[138] the IRS rejected that method and outcome. It instead tested the returns of the patent owner rather than those of the distributor and required Glaxo US to retain most of the profit as a return to its promotional activities. In sum, despite the notable similarities of the two cases, the IRS determined that the United States was entitled to tax most of the combined Zantac operating profit, with the inventor and manufacturer receiving a relatively small share while the IRS determined that most of the profits on sales of Tagamet could flow untaxed out of the United States to the related foreign inventor and manufacturer.[139]

The government's litigating position in the *Glaxo* case is characteristic of the positions it takes in transfer pricing litigation while its approach in the Tagamet APA is presumably typical of distributor-type APAs entered into by the IRS. Thus, it appears likely that the extreme positions taken in audit, Appeals, and litigation bear little relation to, and indeed may be fundamentally inconsistent with, the more measured, principled methods applied in a successful APA proceeding. The disparity in these approaches cannot be reconciled, and the positions cannot begin to converge toward a consistent application of administrative discretion, as long as applications of the arm's-length principle in the APA context remains shrouded in secrecy.

C. Whistling in the Dark

Aside from privacy issues, the only meaningful riposte to secret law concerns would be the argument that transfer pricing principles are so fully described in the regulations that disclosure of APAs would be duplicative and unnecessary. This is a bit like arguing that one can tell how a dish will taste without making it, as long as one has the cookbook. And what a cookbook. With some exceptions, such as the services cost method,[140] the regulations provide no definitive answers to common pricing problems. Instead, they provide only a framework of general principles to be applied based on the virtually unrestricted judgment of the IRS or taxpayers, who are constrained more by their interpretations of extra-regulatory economic principles and their interpretations of underlying facts than by the regulations themselves. The practical complexity in many specific transfer pricing matters, combined with the drafters' obligation to write something serving all comers, may make vagueness unavoidable, but this is cold comfort to a taxpayer seeking to resolve a concrete issue.

Many of the regulations seem to have been drafted following the prime directive of maximizing the commissioner's discretion to choose among possible outcomes on a case-by-case basis, with little regard for consistency. These passages have an on-the-right-hand, on-the-left-hand tenor, ultimately placing the choice of hands with the commissioner, without much further guidance. For example, consider the question whether the arm's-length standard should be applied to each tax year separately or be applied based on an aggregation of years. Reg. section 1.482-1(f)(2)(iii) gives a general rule (year-by-year separately) and then says that ''it may be appropriate'' to consider results over multiple years. The regulation goes on to list circumstances that ''may warrant'' consideration of multiple years, and it provides that the district director ''may take into account'' this data. The examples show that it is the district director who ''may consider,'' ''may conclude,'' or ''determines.''[141] However, they give no indication of the analysis that the district director should follow in choosing one or the other outcome. Reliance on the district director as an umpire without a rule book, use of the conditional tense, and assessments of the likelihood that one approach will be better than another are pervasive drafting tics. This is true whether one explores aggregating transactions, selecting a best method, identifying comparables, disregarding contractual terms and imputing alternative terms based on a lack of economic substance, pricing intangibles or many services, or dealing with other common problems.

Many examples illustrate the exercises of judgment permitted by this linguistic fog. Unfortunately, however, most of these illustrations do not show a taxpayer how to make real-world choices of its own that are likely to pass muster with the IRS. In many of the examples, the facts are drawn in

[138]The economist who provided the transfer pricing study accompanying the SB Corp. APA application also prepared the study for an APA requested for Zantac and regarded the two cases as closely comparable. *Id.* at 16-17.

[139]The *Glaxo* case was eventually settled without trial. IR-2006-142, *Doc 2006-19012*, *2006 TNT 176-6*.

[140]Reg. section 1.482-9(b).

[141]Reg. section 1.482-1(f)(2)(iii)(B) (''It may be appropriate''), (C) (''may take account''), (E) Example 2 (''may consider''), Example 3 (''may conclude''), and Example 4 (''determines'').

black or white.[142] In others, the commissioner's interpretation of the facts overshadows the facts themselves,[143] and in still others no conclusion is offered, but rather only the fact that the commissioner has a discretionary choice that he can make.[144] In every case, the facts are grossly simplified compared with those of real taxpayers running real businesses. This is evident from any comparison between the length of the fact statements in the examples and those provided in any judicial opinion dealing with transfer pricing.[145]

Of course, section 482 itself authorizes the commissioner to allocate income and deductions between related parties to clearly reflect income, and the courts defer to that delegation of discretion, as long as the allocations are not unreasonable.[146] But the regulations go further by assuming that the commissioner's discretion includes the power to choose and interpret the facts on which any allocation must be based. However, that assertion is unexplored in the examples, because they generally do not provide all the facts that would be evaluated by the commissioner or the process of reasoning by which the commissioner would determine what ultimate facts should be found. Thus, the regulations apprise taxpayers that the commissioner has the power to reinterpret the facts while providing only the most general indications of why (and how) the commissioner would do so.

This is not necessarily to say that the regulations are ill-conceived or problematic in what they say, given the complexity and difficulty of the subject matter. The grant of statutory discretion to the commissioner and the arm's-length standard itself, as well as the drafters' task of writing broadly applicable rules, may make it impossible to write something more definitive. What can be said, however, is that the statute contemplates a legal structure in which many final outcomes are determined by the exercise of administrative discretion, and the regulations focus more on maximizing the asserted scope of that discretion than on defining how it should be exercised in practice.

Discretionary choices based on real facts are constantly made in the APA program. Today, some 20 years after the APA program's inception, there is presumably a rich history of those choices, together with the detailed factual bases on which they were made. If revealed, that history could provide valuable direction for the planning of related-party transactions and the settlement of disputes. Given the frequency with which particular issues are dealt with in the APA program, it must be the case that substantial information concerning the way that the IRS applies law to facts exists and could be disclosed, and that this information would greatly advance an effort to better define transfer pricing outcomes consistently with the way the IRS exercises its statutory discretion.

For example, the APA program has addressed the pricing of U.S. distribution of goods acquired from a related party in perhaps a quarter to a third of all APAs issued — several hundreds of times — yet the IRS has disclosed essentially nothing about whose returns were tested or the methods actually used. Assuming that in most cases the distributor's returns were tested and a comparable profit method was used, it would be useful both to taxpayers and IRS examiners to learn more about (1) how, why, and which comparables were selected; (2) what adjustments to those comparables were usually made and why; and (3) when and why there were departures from the most usual approaches. Indeed, the inter-quartile ranges used and the key factors in the choice of range could probably be aggregated and released without disclosing any taxpayer's secret financial data or identity. This type of reporting would have the potential to improve taxpayers' reporting and the quality of IRS audits, and it might be useful to a judge in resolving disputes. Yet no effort has been made to disclose any portion of these or other similarly useful categories of information.

VI. Darkness at Noon

A. Secrecy and Inconsistency

Taxpayers' perceptions that the IRS fairly and consistently administers the law contribute to high levels of voluntary compliance. Those perceptions can only emerge from comparisons among positions taken by the IRS and the reconciliation of apparently disparate results. It is partly for these reasons that Congress required the publication of

[142] *See, e.g.*, reg. section 1.482-3(d)(4), Example 1 (assuming away all ambiguities to conclude that an arm's-length range can be established).

[143] *See* reg. section 1.482-6(c)(3)(iii) ("Given the facts and circumstances, the district director determines under the best method rule that a residual profit split will provide the most reliable measure of an arm's length result.").

[144] *See supra* note 141.

[145] Another example of the detail that is possible and is warranted in examples dealing with complex matters can be found in the JCT's recent report on transfer pricing. *See* JCT, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," JCX-37-10 (July 20, 2010), at 51-102, *Doc 2010-16144*, *2010 TNT 139-13*.

[146] *See, e.g., Sundstrand*, 96 T.C. at 353 (noting that the commissioner's transfer pricing determination "is presumptively correct," that the taxpayer "has the burden of disproving that determination," and that the commissioner's transfer pricing determination "must be sustained absent a showing that he has abused his discretion").

most advance rulings.[147] With no disclosure of the holdings of individual APAs and no alternative disclosures in the fatally bowdlerized annual reports, taxpayers must accept as a matter of faith the proposition that transfer pricing rules are administered evenhandedly. Yet available evidence suggests that this faith is being abused. The administrative philosophy underlying the regulations' emphasis on the commissioner's unfettered discretion to interpret section 482 as he pleases in each case can only flow from a view that the resolution of one taxpayer's case does not matter to the resolution of another. Judicial rejection — and, one might reasonably say, castigation — of IRS litigating positions suggests that the prevailing IRS approach in transfer pricing litigation is purely result oriented. Otherwise, it is hard to understand why the IRS would litigate a case that would lead a judge to describe the IRS's main problem as ''the implausibility of [its] flimsy determination.''[148]

There is other evidence of the IRS's confidence in its ability to find correct arm's-length outcomes on an ad hoc basis without reference to previous decisions or concerns about inconsistency. As noted above, one example is the IRS's view that it need not acknowledge or explain the difference between the Tagamet APA and its litigating position in the *Glaxo* case.[149] Although administering the APA program in a consistent fashion would presumably require access to information concerning the ways in which recurring problems were resolved in the past, apparently no index of completed APAs even existed within the IRS for many years.[150] Further, the annual report provides disassembled statistical data, but no information describing the methods reported to tested parties, risks, or functions. This seems emblematic of a view that — for example, in the case of distributor APAs — nothing of value to future APAs can be learned from analyzing past resolutions of recurring problems.[151]

B. Limited Impact of APA Program

An original objective of the APA program was to obviate the need to resort to the ''traditional adversarial process'' for transfer pricing issues. In expensive and messy litigated disputes, the IRS had historically taken aggressive positions while the courts tended to throw up their hands at a lengthy and sometimes incomprehensible record but seldom sustain the IRS's position. As now operated, it is not possible to say that the APA program has much impact on potential litigation. The number of cases dealt with in the APA program is small, and most taxpayers embroiled in difficult audits probably view the program with skepticism.

The idea of using the APA program's evenhanded assessment of transfer pricing issues to mitigate the extreme positions taken in litigation is a sound one. But the small size of the APA program, the participation of IRS auditors, and the secrecy surrounding substantive analysis and outcomes essentially consigns the APA program to a minor role. Disclosure of more specific information concerning selection of methods, the use of market data, and the ranges of resulting outcomes would likely have a much greater impact on the selection of cases for litigation and on the positions taken both by taxpayers and IRS agents in those cases.

C. Lack of Development of the Law

As *Veritas* illustrates, transfer pricing litigation continues to be mired in the bog that has existed at least since *Eli Lilly* was decided some 25 years ago. An amazing amount of intellectual effort has gone into more fully developing a theory of how pricing problems should be analyzed and what pricing approaches might make sense. This thinking is now memorialized in Treasury studies, regulations, and OECD pronouncements. The common characteristic of all that has been written, however, is that it is highly theoretical and is concerned principally with the assertion of the commissioner's discretion to

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[147] *See supra* at 660-663. For the importance of consistency in other contexts, see *BMW of North America*, 517 U.S. at 587 (Breyer, J., concurring) (''uniform general treatment of similarly situated persons . . . is the essence of law itself''); *Henry v. INS*, 74 F.3d 1, 6 (1st Cir. 1996) (an administrative agency may not ''flit serendipitously from case to case, like a bee buzzing from flower to flower, making up the rules as it goes along''); *Jones v. Califano*, 576 F.2d 12, 20 (2d Cir. 1978) (citations omitted) (Although agencies are not inflexibly bound by the rule of *stare decisis*, neither is their discretion unlimited. ''Thus, courts . . . have held that agencies may not 'treat similar situations in dissimilar ways.'''); *Contractors Transport Corp. v. United States*, 537 F.2d 1160, 1162 (4th Cir. 1976) (Under the Administrative Procedure Act, 5 U.S.C. section 706(2)(A), the courts set aside an agency action that is arbitrary or capricious, including agency decisions that accord ''markedly different treatment'' to parties in ''substantially similar circumstances'' without any ''basis for [the] uneven disposition'').

[148] *Veritas*, 133 T.C. at 315. This is not the only case in which a judge has had particularly harsh words for the IRS's position in a transfer pricing case. *See also Sundstrand*, 96 T.C. at 347-348 (''Throughout these proceedings respondent has skipped from one theory to another in a seemingly futile attempt upon which to hang his section 482 allocation.'').

[149] *Supra* at 673-674.

[150] This observation is based on discussions with former APA program personnel.

[151] While beyond the scope of this report, it seems likely that some IRS programs, such as prefiling agreements and the compliance assurance process program, which conflate the examination and rulings processes, pose similar challenges to principles of consistency and disclosure of secret law.

choose, in an ad hoc way, how to deal with any particular fact situation, no matter whether or how similar situations have arisen and been resolved in the APA program.

Whether secret or not, the actual exercises of administrative discretion in the APA program constitute a part of the law of transfer pricing. They reflect the commissioner's view of the meaning and operation of his regulations, and they form a body of law that the commissioner should respect and apply in dealing with other taxpayers. In some circumstances, despite the discretionary nature of these outcomes, taxpayers are entitled as a substantive matter to treatment that is consistent with that provided to another taxpayer through the APA program.[152] Disclosure of meaningful substantive information concerning these determinations and administrative explanations of the reasons for any departures from them would create a foundation for a law of transfer pricing that goes beyond the Delphic utterances of the regulations and provides real meat and potatoes for an auditor, a taxpayer, an Appeals officer, or a judge to dig into when resolving actual cases.

D. Uneven Access to IRS Working Law

By enacting section 6110 in 1976, Congress sought to eliminate the advantages that a privileged class of Washington insiders had in applying for letter rulings. They were concerned that a private ruling system known only to a few members of the tax profession had been created and that this tended to reduce public confidence in the tax law, because the secrecy surrounding the rulings ''generated suspicion that the tax laws were not being applied on an even-handed basis.''[153] At one time, it might be said that everyone seeking an APA was in the same boat. Few APAs had been issued, and hence little working law had been developed. Further, the APA program divulged no information concerning the economic content of the agreements entered into, and all taxpayers initiated an application with the same lack of information.

This is no longer the situation. The APA program has been in existence for nearly two decades, and a number of former APA program officials now work in the private sector. Further, a small group of economists specialize in the economic analysis required to obtain an APA. The firms that employ those former insiders and specialists tout their specialized expertise and insider knowledge of the APA program and draw on their knowledge of the IRS and its past agreements in advising and advocating for clients. Thus, while unpublished, the working law of the APA program is essentially available to any taxpayer who is willing and able to hire one of these firms to prosecute an APA application, but that working law is unavailable to anyone else. This violates one of the principal concerns that Congress had in requiring the disclosure of other forms of IRS guidance.

E. Waste of Resources

The waste of resources by taxpayers and the government in transfer pricing disputes is staggering. The tax liabilities at issue can be extremely large. Further, because an economic analysis of a pricing issue requires an understanding of all business functions and risks undertaken by each related party, the scope of potentially relevant documents and witnesses can be vast. Compounding the breadth of issues, the disputes may span many years and cover multiple lines of business. Moreover, defining the relative contributions of the parties often requires recounting the corporate history of the development of the products or intangibles many years before the tax years at issue.

As a result of the extensive scope of this exercise, the administrative process can drag on for many years while company witnesses age or move on to other jobs. Should the case proceed to court, discovery can take years and require production of millions of pages of documents. Trial can consume weeks or months, involving numerous fact witnesses and highly compensated expert witnesses. The costs to both parties when all is said and done can be tens of millions of dollars. Thus, perhaps more than for any other tax issue, better information on the application of administrative discretion would pay significant dividends in terms of dispute avoidance and resource conservation.

F. International Implications

Administrators of transfer pricing policy in other countries have for several decades adopted and adapted innovative U.S. approaches. The United States' adoption of the commensurate-with-income concept in the Tax Reform Act of 1986 has led to similar enactments in other countries.[154] Treasury's white paper on transfer pricing[155] led not only to a rethinking and redrafting of U.S. regulations, but also to a rethinking of the OECD guidelines generally looked to in many other countries and in many

[152]*See supra* note 19.

[153]*See* TRA 1976 bluebook, *supra* note 52, at 303-304.

[154]For example, despite significant criticism, Germany enacted a similar requirement effective January 1, 2008.

[155]Notice 88-123, 1988-2 C.B. 458.

competent authority proceedings.[156] U.S. enactment of draconian transfer pricing penalties led to the imposition of similar regimes in other countries,[157] as did U.S. promulgation of contemporaneous documentation requirements.[158] And following U.S. implementation of its APA program, many other countries followed suit.[159]

Just as our treaty partners have often followed the U.S.'s lead in codifying transfer pricing principles and putting APA frameworks into place, so too have they followed the IRS's lead in choosing to restrict information concerning taxpayer outcomes in their programs. The countries that have published annual reports of APA activity appear to have followed the U.S. model. For example, the Italian Revenue Agency APA Bulletin for 2005 through 2009 contains little more than charts similar in nature to those in the U.S. APA annual reports.[160] Like the U.S. APA annual reports, the Italian report ends with a disclaimer that the document ''does not constitute a standard document, nor does it aim to provide guidelines to the application of the arm's length principle.''[161] Reports issued by Australia, Canada, Japan, and South Korea also follow suit.[162]

The ultimate result of all of this secrecy is that transfer pricing law essentially amounts to elaborate sets of ambiguous and sometimes conflicting conceptual rules frosted with the suggestion that the government agency tasked with implementing them has carte blanche to do pretty much as it pleases, without concern that questionable outcomes will see the light of day or concern that its discretion must be exercised consistently from case to case. Taxpayers with related-party transactions are left to set their prices based solely on these conceptual rules with limited guidance on how they should or must be interpreted.

In fact, despite numerous APA rulings, virtually the only publicly available concrete applications of the law occur in litigated cases, in which the taxing agencies tend to take extreme positions based on their supposed discretionary powers.[163] The courts generally reject these positions, and with them, the agency's perspective on its discretion. But the courts' opinions provide little useful guidance, because they tend to be fact intensive and because of the polarity of the parties' positions.[164] In sum, transfer pricing

[156]The OECD studied the United States' commensurate-with-income requirements and issued new guidelines for dealing with intangibles that did not adopt similar requirements.

[157]Since the United States adopted transfer pricing penalties in 1990, several other countries have followed suit, including Australia, Canada, Mexico, and the United Kingdom.

[158]The United States has required contemporaneous documentation for penalty protection for tax years beginning after December 21, 1993. Countries that have implemented contemporaneous documentation requirements since then include Canada (1998), Taiwan (2005), Sweden (2007), Turkey (2007), South Korea (2008), and France (2010).

[159]Japan's APA program preceded the U.S. program by several years (1987); those that implemented a program after the U.S. program had been started include Canada (1994), New Zealand (1994), Australia (1995), Mexico (1995), South Korea (1996), China (1998), the United Kingdom (1999), France (1999), the Netherlands (1999), Germany (2000), Italy (2004), the Czech Republic (2006), Hungary (2007), Portugal (2008), and Sweden (2010).

[160]The table captions are as follow: ''Applications for international standard rulings submitted during the period 2004-2009''; ''International ruling agreement completion time''; ''Methods used for determining transfer prices''; ''Classes of taxpayers by turnover''; ''Industry according to Ateco 2002 code''; ''Industry'' [grouping the economic activities illustrated in the prior table ''according to the macro-categories worked out by the Confindustria Research Centre]''; ''Relationships between associated parties''; and ''Cases [types] of transactions in the agreements signed [listing sale of tangible property into Italy, purchase of foreign goods, performance of services by Italian entity, performance of services by non-Italian entity, cost sharing agreements, transactions involving intangible property, and attribution of profits or losses to a permanent establishment].''

[161]*Id. See* Italian Revenue Agency APA Bulletin for 2005-2009 (Apr. 21, 2010).

[162]*See, e.g.*, Canada Revenue Agency, Advance Pricing Arrangement Program Report 2008-2009 (listing statistics for, among other things, ''APAs by Transactional Issue'' (''Tangible Property,'' ''Intangible Property,'' ''Intra-Group Services,'' and ''Financing''); ''APAs by Transfer Pricing Methodology'' (''Comparable Uncontrolled Price/Transaction,'' ''Cost Plus,'' ''Resale Price,'' and ''Transactional Net Margin Method'' (with PLI specification: Berry Ratio, Operating Margin, Return on Assets, or Total Cost Plus); and ''APAs by Industrial Sector''); Australian Taxation Office (ATO), Advance pricing arrangement program 2008-09 update (listing statistics for, among other things, ''APAs completed by type of dealing'' (''Tangible property,'' ''Intangible property,'' and ''Services''); ''primary methods applied in the APAs'' (''TNMM/Sales,'' ''TNMM Costs/Berry,'' ''Profit split,'' ''CUP,'' and ''Cost plus'')).

[163]This is often true outside the United States as well, as evidenced by recent court opinions in Canada and Australia. *See, e.g., GlaxoSmithKline v. The Queen*, 210 F.C.A. 201 (July 26, 2010), *Doc 2010-16618* (Canada's Federal Court of Appeals unanimously reversed the Tax Court of Canada and rejected the CRA's attempt to price GlaxoSmithKline's Canadian affiliate's purchase of ranitidine at the price paid by generic manufacturers while disregarding a license that allowed the Canadian affiliate to use Glaxo's trademarks and brand); *SNF (Australia) Pty Ltd v. Commissioner of Taxation*, [2010] FCA 635 (June 25, 2010), *Doc 2010-14326* (Federal Court of Australia rejected the ATO's attempt to determine an arm's-length result by reference to the taxpayer's actual position rather than on the basis of a hypothetical fair market value and accepted the comparable uncontrolled price method applied by the taxpayer, rather than the TNMM applied by the ATO).

[164]*See* cases cited at notes 113-118.

law is both over-conceptualized and underdeveloped, and the underdevelopment arises in large part from the choice of most nations, led by the United States, not to disclose concrete outcomes other than in a litigation context, in which IRS positions are usually rejected as arbitrary and capricious.

VII. Rosy-Fingered Dawn

A. Add Disclosure to APA Objectives

By the end of 2009 chief counsel had issued approximately 900 APAs, and these APAs addressed, under real-world circumstances, many common transfer pricing issues over and over again. For example, APAs dealt with the proper treatment of distribution services more than 130 times, with R&D services nearly 70 times, and with approximately 25 other categories of service 10 or more times. They addressed sales of tangible property into the United States more than 400 times, and the use of intangible property by related parties nearly 300 times. All in all, the annual reports indicate that APAs have addressed pricing issues involving services 1,305 times and pricing issues involving property 1,505 times since the APA program began. The reports also include tables listing the number of times particular TPMs were used (a total of about 1,500 instances, heavily favoring CPM methods using one of the common profit level indicators). However, not much more is revealed concerning the thinking of APA program staff in the issuance of APAs.

It appears that the IRS is giving insufficient thought to the extent to which interpretations of law applied in the APA program could or should be made generally available. As discussed above, the secret law concern expressed in the legislative history to the report requirement was essentially ignored in the first report, and later reports have simply followed that pattern. Surely there is something that can be disclosed concerning the IRS's development of transfer pricing law through the APA program. For example, for the more than 300 instances in which distribution, marketing, and selling were considered, there must be some recurring characteristics as well as recurring differences that affect the choice of TPMs, the choice of comparables, and the decision whether adjustments to market yardsticks are necessary. An understanding of those factors and their consequences would clearly be useful to those seeking to comply with transfer pricing rules. Yet it appears that the IRS is giving little attention to the possibility that the APA program is generating approaches and outcomes of a substantive legal nature that should be disclosed. The IRS should change this mindset by making disclosure of the substance of APAs a specific objective of the APA program.

B. Establish an APA Disclosure Office

A disclosure objective is likely to be put into practice only if the completion of those disclosures is the principal job of professional personnel on the APA staff. Accordingly, the APA program's budget should include funding for one or more professionals whose job descriptions focus on disclosure of the working law applied in the issuance of APAs. Meeting meaningful disclosure objectives should be one of the measures by which the performance of the APA program and its senior staff are evaluated.

C. Require Sanitized Disclosure

It is problematic to require disclosure of the working law of the APA program solely through an annual report that is limited to aggregate data from multiple APAs. Routinely synthesizing the principles at work in multiple APAs would involve an interpretive effort that goes beyond the analysis required for any particular APA and would be more in the nature of the development, rather than disclosure, of working law. As such, difficulties and delays would inevitably arise.

A simpler and better approach — and the only one providing information concerning the actual legal determinations — would be to disclose, with appropriate privacy safeguards, the substantive content of individual APAs. A similar proposal existed in early versions of the legislation that eventually led to the addition of APAs to section 6103's definition of return information. Proposed legislation originally included a provision requiring that the APA annual report include, for each APA, ''the summary of the methodology used in each such agreement and a hypothetical illustration of the methodology's operation.'' The bill then provided that the IRS could enter into an APA ''only if all parties to such agreement agree on the summary and illustration.''[165]

This proposal, which would require congressional approval, should be resurrected, with greater emphasis on disclosure of the facts supporting use of the method. Doubtless, this would lead to complaints that the privacy of the taxpayers receiving APAs is being compromised, that the content of alternative dispute resolutions should not be disclosed, that disclosure would give APAs an unintended precedential stature, and that meaningful disclosure cannot be made if APAs are sanitized to protect recipients' identity and financial information.

The question of whether the characterization of APAs as alternative dispute resolutions should

[165]H.R. 2378, section 2(a)(2)(F) and (2)(c).

shield their disclosure has been discussed above.[166] As to other privacy concerns, much could surely be disclosed without directly or indirectly revealing the identities of APA recipients. However, to the extent that meaningful information concerning the substance of APAs risks going further, privacy of taxpayer information, while important, is not a principle that overrides all other policy concerns. In the current edition of CCH's two-volume Internal Revenue Code, section 6103 spans 43 pages, two of which are taken up in stating the principle that return information (including information regarding an APA) is confidential, with the remaining 41 pages outlining the various exceptions to that rule. The strongest justifications for blanket privacy exist for the disclosure of information, such as tax returns, that is legally required of individuals, not for the disclosure of information voluntarily provided by publicly traded corporations in the hope of gaining an advantage in their tax affairs. In the case of APAs, privacy values should be weighed against the importance of public disclosure of IRS working law, and a balance between these two sometimes conflicting values should be struck.

D. Rethink Content of Annual Reports

The IRS could disclose much more relevant information concerning the APA program, and it should rethink the scope and content of its annual reports with that objective in mind. Beginning with the first report, the IRS has taken a minimalist approach, focusing on what statutorily must be disclosed, rather than what can be or should be disclosed. Thus, the report marches through the statutory list[167] of required data, interprets the categories as narrowly as possible, and effectively discloses nothing of substance concerning the IRS's determinations. When the statutory language requires "general" descriptions, one might reasonably conclude that Congress intended the word to prevent disclosure of taxpayer-specific information. However, the IRS has interpreted the word to support a level of abstraction that cloaks any glimmer of substance. This leads to any number of shortcomings, one of the most basic of which is the report's treatment of the statute's requirement that it disclose the "methodologies used to evaluated tested parties" and "the circumstances leading to the use of those methodologies."[168]

Rather than treat the enumerated list of required elements, interpreted as narrowly as possible, as the complete roster of information that should be disclosed, the IRS should instead treat the disclosure of the substance of APAs issued over the reporting period as the objective of the report and then do its best to achieve that objective within the constraints of the code and the statute. In doing so, the IRS could take comfort from the legislative history of the report requirement — which condemns the development of secret law — and from the provision in the reporting statute that permits the IRS to make any disclosure it wishes, as long as disclosure would have been permitted under the section 6110 redaction rules and the disclosed information cannot be associated with a particular taxpayer.

E. Limit Secrecy to Set Time Period

The principal argument for secrecy made by APA recipients has been that the disclosures required for APA requests include trade secrets and confidential, detailed financial information concerning operations. Because of the sensitivity of this information, it is argued, any disclosure would seriously damage the corporate business, and this risk should not have to be taken to agree on a pricing method.

These are weighty concerns, but they also tend to be time-sensitive. As time passes, patents expire, products and supply chains change, and corporate organizations are altered. Financial data that was sensitive at one time tends to become irrelevant to current operations. Yet the legal content of an APA — what methods the IRS is prepared to approve and accept in a particular context — can remain relevant and important for decades. Unlike sensitive commercial information, the economic and legal principles applied endure. Today, two decades after the commencement of the APA program, there must be many APAs that, like the Tagamet APA, involve public corporations that are no longer independent, products whose patents have expired, and supply chains that have been fundamentally altered. Thus, the weight of the arguments supporting secrecy tends to decline over time while that of the arguments supporting disclosure does not.

Disclosure of unredacted APAs and their unredacted background files should be made when the disclosure can no longer do real competitive damage. Those disclosures would provide a more complete record of the financial and other information necessary to fully understand the factual predicate leading to the selection of tested parties, methods, and comparables as well as the reasons that the business was characterized in a particular way. It is important to keep in mind that an APA recipient has no right to confidentiality concerning the IRS's approach in determining the way in which the arm's-length standard should be applied. The secrecy of that approach is simply the side effect of other, legitimate confidentiality concerns whose significance, unlike that of the legal approach, wanes

[166] *Supra* at 666-667.
[167] Tax Relief Extension Act of 1999, section 521(b).
[168] *Id.* at section 521(b)(2)(D)(iv).

over time. It might be reasonable, for example, to limit the confidentiality of an APA and its background files to 10 or fewer years unless the taxpayer can make an affirmative showing that disclosure at that point would put it at serious competitive disadvantage; and, for those APAs not disclosed under this rule, to provide for full disclosure at regular intervals thereafter, subject to further taxpayer showings that disclosure remains a serious competitive problem.

VIII. Conclusion

The administration of transfer pricing law without disclosure of any meaningful substantive information regarding past APAs admits both IRS agents and taxpayers to a funhouse in which distorted results cannot be contested by resort to prior practice. Because no information is generally available regarding actual APA outcomes, IRS agents may pursue lines of reasoning that would be rejected by the APA program, and taxpayers with unusual problems or engaged in adversarial audits are unlikely to be comfortable seeking a prospective resolution there. Further, the information concerning outcomes in the APA program is, as a practical matter, largely concentrated in the hands of former insiders and specialists. Because the IRS generally takes extreme positions in litigation, and because its positions seldom prevail, case law does not provide a meaningful antidote. Moreover, the regulations have not adequately advanced the law, because they are concerned mainly with the statement of broad principles in a way that is sufficiently ambiguous to preserve IRS discretion and to permit a broad range of outcomes.

These problems are exacerbated by the choice of Congress and the IRS, with the support of APA recipients, to keep the substance of APAs out of the public domain. Meaningful disclosure of APA substance could aid in the development of transfer pricing law and the resolution of transfer pricing disputes within a shared framework. It would also likely increase the importance of the APA program by making it more likely that taxpayers would seek APAs for difficult problems, and it would eliminate the secret law problems with APAs that, in the context of letter rulings and other forms of guidance, Congress and the courts disposed of many years ago. It would likely even alter the conduct of some taxpayers as they acquired an understanding of the pricing approaches applicable to them that had passed muster with the IRS.

Some of the proposals made above could be implemented without congressional action. Others should be elements in legislation to improve the administration of transfer pricing law. Overall, the availability of better information concerning APA outcomes likely would substantially improve the administration of transfer pricing rules, facilitate development of the law, and reduce the costs of both compliance and enforcement.[169]

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[169]While beyond the scope of this report, the concerns raised about APAs can also be viewed as concerns with the competent authority process, in which greater disclosure of principled outcomes would likely lead over time to better definition of OECD guidelines, better development of transnational transfer pricing law, and less aggressive conduct by some taxpayers. Similarly, many of the criticisms of the secrecy of the APA program could be made of other IRS programs, in which legal advice is effectively given in an advance context and without public disclosure, such as the program for the issuance of prefiling agreements.

Table 2. Summary of Table 1 in 2002 to 2010 Annual Reports

	2002		2003		2004		2005		2006		2007		2008		2009		2010		Total		Number of Corps With CFCs in NAICS
	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	
APA Recipients by NAICS Code																					
Computer and electronic product manufacturing — 334	13	15	19	21	4	6	10	12	7	9	7	9	10	12	10	12	4	6	84	102	745
Wholesale, trade, durable goods — 421	1	3	4	6	4	6	7	9	1	3	10	12	16	18	16	18	10	12	69	87	2,367
Electrical equipment, appliance, and component manufacturing — 335	4	6	16	18	7	9	1	3	7	9	10	12	7	9	7	9	1	3	60	78	495
Miscellaneous manufacturing — 339	1	3	7	9	1	3	1	3	1	3	4	6	10	12	10	12	1	3	36	54	919
Transportation equipment manufacturing — 336	4	6	7	9	1	3	4	6	1	3	1	3	4	6	4	6	7	9	33	51	275
Chemical manufacturing — 325	4	6	1	3	4	6	1	3	1	3	4	6	4	6	4	6	4	6	27	45	402
Wholesale trade, nondurable goods — 422	1	3	4	6	4	6	1	3	1	3	1	3					10	12	22	36	* (see p. 684)
Machinery manufacturing — 333	4	6	1	3	1	3	4	6			4	6	1	3	1	3	1	3	17	33	412
Securities, commodities contracts, and related activities — 523	1	3	1	3	1	3	7	9	4	6	1	3	1	3	1	3			17	33	706
Motor vehicles and parts dealers — 441	1	3	1	3	1	3	1	3	1	3	1	3	1	3	1	3	4	6	12	30	124
Apparel manufacturing — 315	1	3	4	6	1	3	1	3	1	3			1	3	1	3	1	3	11	27	99
Food manufacturing — 311			1	3	1	3	1	3	4	6	1	3	1	3	1	3			10	24	155
Professional, scientific, and technical services — 545	1	3					1	3					4	6	4	6	1	3	11	21	3,376
Information service and data processing services — 514	1	3			1	3	1	3	1	3	4	6					1	3	9	21	228
Beverage and tobacco manufacturing — 312	1	3	1	3	1	3	1	3	1	3	1	3	1	3	1	3			8	24	51
Air transportation — 481	1	3	1	3	1	3	1	3	1	3	1	3	1	3	1	3			8	24	27
Broadcasting and telecommunications — 513	1	3	1	3	1	3	1	3			1	3							5	15	38
Oil and gas extraction — 212					1	3							1	3	1	3	1	3	4	12	123
Plastics and rubber products manufacturing — 326							1	3			1	3	1	3	1	3			4	12	377
Fabricated metal manufacturing — 332					1	3			1	3	1	3					1	3	4	12	427
APA Recipients by NAICS Code																					
Food and beverage stores — 445			1	3					1	3	1	3					1	3	4	12	31

Table 2. Summary of Table 1 in 2002 to 2010 Annual Reports *(continued)*

	2002		2003		2004		2005		2006		2007		2008		2009		2010		Total		Number of Corps With CFCs in NAICS
	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	
APA Recipients by NAICS Code																					
Health and personal care stores — 446	1	3					1	3					1	3	1	3			4	12	270
Clothing and clothing accessories stores — 448			1	3			1	3	1	3	1	3							4	12	54
Sporting goods, hobby, book, and music stores — 451			1	3	1	3			1	3	1	3							4	12	256
Publishing industries — 511	1	3	1	3							1	3					1	3	4	12	328
Credit intermediation and related activities — 522					4	6													4	6	291
Accommodation — 721					1	3							1	3	1	3			3	9	99
Mining (except oil and gas) — 211			1	3			1	3											2	6	76
Wood product manufacturing — 321											1	3					1	3	2	6	47
General merchandise stores — 452													1	3	1	3			2	6	15
Heavy construction — 234							1	3											1	3	42
Paper manufacturing — 322			1	3															1	3	78
Petroleum and coal manufacturing — 324											1	3							1	3	43
Nonmetallic mineral product manufacturing — 327			1	3															1	3	91
Primary metal manufacturing — 331			1	3															1	3	130
Furniture and related products manufacturing — 337	1	3																	1	3	43
Electronic and appliance stores — 443																	1	3	1	3	67
Water transportation — 483											1	3							1	3	54
Pipeline transportation — 486									1	3									1	3	50
Motion pictures and sound recording industries — 512											1	3							1	3	58
Insurance carriers and related activities — 524							1	3											1	3	444
Food services and drinking places — 722					1	3													1	3	99
Total	**43**	**81**	**77**	**123**	**43**	**87**	**50**	**96**	**37**	**75**	**61**	**111**	**67**	**105**	**67**	**105**	**51**	**87**	**496**	**870**	**11,874**
Number of APAs executed	55		85		58		65		53		82		81		68		63		610		

Table 2. Summary of Table 1 in 2002 to 2010 Annual Reports *(continued)*																			
	2002		2003		2004		2005		2006		2007		2008		2009		2010		Total		Number of Corps With CFCs in NAICS
	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	min	max	
APA Recipients by NAICS Code																					
Less renewals	-16		-21		-17		-21		-16		-35		-29		-24		-28		-207		
New transactions covered by APAs	39		64		41		44		37		47		52		44		35		403		
Percentage of APAs that are new covered transactions	71%		75%		71%		68%		70%		57%		64%		65%		56%		66%		
**See* Wholesale trade, durable goods — 421.																					