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On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation

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ON THE FRONTIER OF PROCEDURAL INNOVATION: ADVANCE PRICING AGREEMENTS AND THE STRUGGLE TO ALLOCATE INCOME FOR CROSS BORDER TAXATION

*Diane M. Ring**

INTRODUCTION	144
A. <i>Context of the Project</i>	144
B. <i>Specific Project</i>	145
I. PRESSURES ON THE SYSTEM: TRANSFER PRICING MELTDOWN.....	150
A. <i>The Transfer Pricing Demon</i>	151
B. <i>Historical Treatment of Transfer Pricing</i>	153
C. <i>Service's Unsatisfactory Responses to the Explosion in Transfer Pricing</i>	156
II. INTRODUCTION AND USE OF THE ADVANCED PRICING AGREEMENT PROGRAM.....	159
A. <i>Overview</i>	159
B. <i>Origins of the APA Process—Existing Domestic and Foreign Models</i>	160
C. <i>The APA Procedure</i>	163
III. EFFECT OF THE APA PROGRAM ON PARTICIPANTS: A PROCEDURAL HYBRID ADDRESSING THE DEMAND FOR ADMINISTRABLE TRANSFER PRICING	169
A. <i>APA Program Changes</i>	170
1. <i>How the Procedural Changes Impact Uncertainty</i>	171
2. <i>How the Procedural Changes Impact Difficulty in Dispute Resolution</i>	175
B. <i>Evaluation</i>	183
1. <i>Hybrid Nature of APA Program</i>	184
2. <i>Parallels to Other Regulatory Reform</i>	187
3. <i>Further Questions on the APA Program's Effectiveness</i>	189
IV. EFFECT OF THE APA PROGRAM ON NONPARTICIPANTS: THE SILENT PIECE OF THE PROCEDURAL HYBRID.....	191

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A.	<i>Taxpayer Access and Participation</i>	192
B.	<i>Results and Comparability in APA Process</i>	198
1.	Appropriate Reasons for Varying Results	199
2.	Inappropriate Difference in Results	203
C.	<i>Role of Disclosure in the Impact of APAs</i> <i>on Nonparticipants</i>	204
1.	Disclosure Ex Ante and Ex Post	206
2.	Disclosure in the APA Procedure	209
3.	Assessment of APA Disclosure	213
D.	<i>Assessment of APA Program's Impact</i> <i>on Nonparticipants</i>	218
V.	THE APA PROGRAM AS A CASE STUDY FOR ADMINISTRATIVE LAW THEORY.....	220
A.	<i>Forum for Testing Administrative Law Theories</i>	221
B.	<i>Functional Aspect of APA Program Design Choices</i>	229
	CONCLUSION	232
	SPECIFIC PROJECT.....	232
	BROADER ADMINISTRATIVE CONCLUSIONS	233

INTRODUCTION

A. *Context of the Project*

The past decade has been a tumultuous and energized period in the study of administrative law and regulatory regimes.¹ Debate continues over both positive and normative theories of the administrative state, as well as over the appropriate directions of innovation and "reinvention."² Among legislators and the public, the tax system and the Internal Revenue Service have been targets for criticism.³

1. See Marshall J. Breger, *Regulatory Flexibility and the Administrative State*, 32 TULSA L. J. 325 (1996); Cass R. Sunstein, *Administrative Substance*, 1991 DUKE L. J. 607 (1991); Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1 (1998); see also Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1 (1997) (describing the numerous administrative law critiques, debates and proposals).

2. See Freeman, *supra* note 1, at 3-4 n.3 (citing a range of regulatory literature focusing on "reinvention").

3. In 1996 Congress established the "National Commission on Restructuring the Internal Revenue Service," which gathered facts and made numerous reform recommendations to Congress. In July 1998, President Clinton signed into law the Internal Revenue Service Restructuring and Reform Act of 1998. Pub L. No. 105-206, 112 Stat. 689 (codified at 26 U.S.C.A. § 781 (1999)).

This paper outlines a recent procedural innovation in the tax area, the Advance Pricing Agreement Program ("APA" program)⁴, and evaluates its success. Such a case study can play a significant role in linking procedural innovation to the broader issues of administrative law theory and regulatory reform. For example, a working model such as the APA program, built on flexibility and creativity, may support administrative theories advocating discretion, flexibility, and experimentation.⁵ Conversely, some interest group theories of regulation (e.g., public choice theory), can prompt critical examination of reforms like APAs that exhibit limited openness to scrutiny.⁶ The APA program is an ideal candidate for such analysis because it incorporates multiple factors germane to other fields including cross border transactions, intergovernmental relations, high information costs for regulation, and serious risks to all parties from uncertainty. Ultimately, detailed understandings of innovations in administrative systems are essential to developing and challenging positive and normative theories of administrative law—and to designing concrete applications of administrative law policy.

B. Specific Project

In the field of international tax, there has developed a national, and even international consensus that traditional mechanisms for administering the law and resolving disputes have virtually collapsed in the area of transfer pricing (which plays an important role in allocating a taxpayer's income among taxing jurisdictions).⁷ The tax system no

4. Given the administrative aspects of this paper, it is unfortunate that the acronym for the tax program in question is the same as that for the Administrative Procedures Act. However, because the tax program is known exclusively as the "APA program," this paper retains that terminology throughout. Thus, any reference to "APA" in this paper applies only to the tax program and its products.

5. See, e.g., Freeman, *supra* note 1, at 22, 82–83, 97 (arguing that discretion constraining approaches to regulatory reform may fail to address the most important administrative issues, and outlining a collaborative governance model that involves agency flexibility and provisional regulatory solutions to maintain receptiveness to change). For a discussion of the origins of the APA program, see *infra* text accompanying notes 46–70.

6. See, e.g., Croley, *supra* note 1, at 39–41 (noting in a comparison and critique of major theories of administrative law, that "public choice" theorists consider the regulatory system to favor organized, narrow interest groups and thus such theorists advocate less reliance on government and regulation).

7. In the most general sense, transfer pricing is a technical term that refers to the amounts related parties charge each other in transactions. However, in tax analysis the term has a more negative connotation because it also encompasses how parties might benefit from these pricing decisions. See, e.g., GENERAL GOV'T DIV., GENERAL ACCOUNTING OFFICE, INTERNATIONAL TAXATION: TRANSFER PRICING AND INFORMATION ON NONPAYMENT OF TAX (1995) [hereinafter "NONPAYMENT OF TAX"].

longer effectively administers these rules.⁸ The significance of administrative failure here is tremendous. As described in greater detail in Part I, transfer pricing essentially refers to the prices related parties charge each other in transactions. If the parties agree to an artificially high or low price for the goods, services, intangibles or borrowing, they can strategically place their total profits in the “best” (i.e. lowest tax) country. Such off-market pricing is possible because the parties’ common control or ownership means they share a common economic interest.

Given the volume of cross border business between and among the United States and other countries, much of which involves related party transactions, the opportunity for transfer pricing abuse by taxpayers and the resulting loss of tax revenue continues to be staggering. Successful application and enforcement of U.S. tax rules designed to prevent transfer pricing abuse typically require a very fact intensive review with economic analysis, detailed regulations, and third party comparative data. Often, necessary information is outside the United States, does not exist in relevant forms, or does not exist at all. The situation is compounded by the fact that other taxing jurisdictions, which may consider their own revenue at stake, can take a different view of the proper price—disagreeing with the United States, the taxpayer, or both.⁹ Expressing serious concern about the loss of revenue from transfer pricing, Congress recently directed the Internal Revenue Service (“Service”) to prepare a report on the current transfer pricing situation. The resulting report concludes that the “average annual [transfer pricing] gross income tax gap is estimated to amount to \$2.8 billion.”¹⁰ Even before this most recent report, the Service recognized the severity of the transfer pricing problem and undertook aggressive reform aimed at improved administrability.¹¹

8. The challenges of this tax problem produced an explosion of audits and litigation that have come to dominate much of the Service’s and courts’ time. *See, e.g., id.* at 21–22 (for cases closed in fiscal year 1993 and the first half of fiscal year 1994, the Service spent 1/3 of its total international examiner time and much more of its economists’ time on cases with an I.R.C. § 482 issue). *See infra* text accompanying note 34 (discussing burden on the tax system from transfer pricing).

9. *See infra* text accompanying notes 17–19 (describing transfer pricing examples)

10. *IRS Report on Application and Administration of I.R.C. § 482* (Pub. 3218), 1999 DAILY TAX REP. 108, at L-3.

11. The tax system could not sustain the current approach that (1) relied on complex regulations that failed to provide a clear answer in most cases, (2) involved highly individualized factual/legal determinations, and (3) ultimately required coordination with a separate sovereign. These difficulties in enforcing the transfer pricing regime seemed intractable and not susceptible to substantial remediation through regulatory changes. *See infra* text accompanying notes 38–44. The Service, therefore, sought an alternative beyond modification of the detailed substantive tax rules and regulations.

In a bold move in the early 1990s, the United States led its trading partners toward a new model of advance dispute resolution for transfer pricing, the APA program, which relies on a backbone of familiar mechanisms complimented by certain novel features.¹² The APA process is an alternative to the standard taxpayer path of doing the transactions, filing a return, facing audit (some level of audit is more likely with larger taxpayers), and, finally, possible appeal with settlement or litigation. The taxpayer initiates the APA process by approaching the Service (and typically the corresponding tax authorities in the other relevant jurisdictions) *before* engaging in the related party transactions potentially at issue.¹³ At this point the taxpayer voluntarily provides detailed information to the governments regarding its business activities, plans, competitors, market conditions, and prior tax circumstances. The critical piece of this presentation is the taxpayer's explanation of its planned pricing method. Following discussion and negotiation, the parties hopefully reach agreement on how the taxpayer should handle the pricing of these anticipated related party transactions. This understanding is embodied in the APA agreement which typically runs for three years.

In order to appreciate the potential issues raised by this innovative procedure it is necessary to outline briefly the features of the process from the perspective of the various parties. First, why would taxpayers participate to the extent it requires disclosure to the government of significant information, some of which might otherwise be withheld? Ideally participating taxpayers obtain tax certainty before actually engaging in their transactions. In addition they obtain a tax treatment that is uniformly accepted by all of the taxing authorities, thereby eliminating conflict. There is also an expectation that this alternative

12. See Rev. Proc. 96-53, 1996-2 C.B. 375 (revising and superseding Rev. Proc. 91-22); Rev. Proc 91-22, 1991-1 C.B. 526 (first introducing the APA process). At its core, the APA program is a mechanism by which taxpayers can approach the Service to develop an agreement on the tax treatment of their related party transactions under transfer pricing rules and related provisions. See I.R.C. § 482 (1999); Treas. Reg § 1.482 (1999) and the regulations thereunder. The agreements, which apply for a specified period of future (and sometimes past) years, have been treated as confidential and not released to the public. However, in early 1999 the Service indicated a change in its views on disclosure of APAs and announced plans to release redacted versions. See *infra* text accompanying note 52. However, Congress responded in December 1999 by categorizing APAs as "return" information under I.R.C. § 6103, which cannot be disclosed. Pub. L. No. 106-170, § 521; 113 Stat. 1860, 1925. Additionally, Congress amended I.R.C. § 6110(b) to exclude APAs from the definition of written determinations required to be disclosed. See *id.* § 521 (a)(2). To provide some increased information regarding the APA program, Congress directed the Secretary of the Treasury to prepare an annual report regarding APAs. See *id.* § 521(b).

13. But see Rev. Proc. 96-53, *supra* note 12, at § 3.06 (outlining rollback provisions).

mechanism for dispute resolution might reduce overall costs of addressing transfer pricing problems.

Second, why should governments be willing to engage in this one-on-one process with taxpayers? Governments may hope to gain information about pricing practices and transaction specific issues, to utilize a different forum, and to interact with other countries in a setting conducive to more comprehensive resolutions of transfer pricing "problems." Additionally, governments, have historically borne a significant burden for transfer pricing, both in terms of time and money. They now look to the APA program to provide less costly dispute resolution and to enhance their information base for future improvements to the taxation of related party transactions.

The participating taxpayers and governments represent the central but not exclusive parties significant to the APA program. Nonparticipating taxpayers (those with and without transfer pricing issues) are impacted by both the tax system's problem with transfer pricing and by the addition of APAs to the mix of procedural options. On the positive side, a successful APA program might reduce government administration and enforcement costs, providing a generalized benefit. Also, to the extent the Service gains more detailed knowledge about transfer pricing practice and can translate that learning into improved rules, then all taxpayers with transfer pricing questions may benefit. On the negative side, the program's use of private individualized agreements raises a number of risks that might not be acceptable in an administrative regime, including the specter of uneven application of substantive law. Not surprisingly, the complex and varied effects of the APA program have made this procedural innovation a lightning rod for both praise and criticism from those concerned with the future of transfer pricing in the U.S. tax system. An in-depth case study of this innovation provides insight into the scope of its effectiveness for taxing cross border income, and into its broader implications for administrative and regulatory reform.

The creation of the APA program illuminates the difficult procedural choices made in a particular administrative regime in response to concrete substantive and procedural problems and goals. But of course, the tax system is not entirely unique. Numerous other administrative agencies confront comparable issues including complex rules, detailed facts, and international players. Thinking about such questions from a more universal administrative law theory perspective allows us to see the connections across a range of administrative regimes and to develop a better understanding of the risks and opportunities in reform.

The first step in this process is to develop a more nuanced understanding of the APA program. The paper asks two questions regarding the program's effects and success: (1) what is the impact on the participants (i.e., does the APA program make transfer pricing more administrable and if so how) and (2) what is the impact on nonparticipants (i.e., what is the effect on the larger community of taxpayers with cross border business activities). This dual focus is necessary for an evaluation of a new procedural development like the APA program. The program does not stand alone; it functions as part of a larger integrated regime, the tax system, and the effects on nonparticipants may be just as important as the effects on participants.

Because the form of the APA program clashes with traditional frameworks for designing and thinking about administrative systems—in particular the distinction between rulemaking and adjudication¹⁴—the program can seem difficult to evaluate. The standard structural protections inherent in a traditional framework play no role. Thus, a central question is how much we are willing to consider alternative mechanisms for addressing administrative discretion, where the upside of the departure from more established practices may be the resolution of intractable problems. Although the workings of the APA program can be examined and critiqued without specific reference to administrative law, such an analysis limits our understanding of both its potential and its risks.

After reaching initial conclusions regarding the effects and success of the APA program on participants and nonparticipants, and the trade-offs at stake in granting this kind of flexibility to the tax system, the paper turns to the second major question—what this success suggests more generally about administrative reform and regulation in an international environment. The fundamental questions of administrative law concern how administrative systems do and should work, and how they can be improved. This inquiry ultimately diverges in two directions. The first follows the more traditional positive and normative analyses of regulatory administrative process with alternative theories based on interest group behavior. The second, though not entirely rejecting such premises, pushes more explicitly for reform and innovation, and considers a “new attitude” essential to any significant reform. Both directions of analysis demand investigation into real administrative practice. This paper undertakes that task for the APA program.

The international applications of the resulting observations may prove the most important because they offer an alternative role for other countries in the U.S. regulatory and administrative process. Such an

14. See *infra* text accompanying notes 163–172.

alternative will be especially valuable in an increasingly international and complex commercial environment where traditional patterns of regulating and decision making by countries may not achieve their shared goals.

To execute this two stage inquiry, Part I describes the background transfer pricing struggles that pushed the Service to explore alternatives to traditional audit and litigation of these tax problems. Part II outlines the introduction of the alternative that emerged, the APA program, and its growth over the past nine years. Part III examines the direct impact of the APA program, whether and how it has made transfer pricing issues more administrable for participants. Part IV considers the indirect impact of the APA program, its relation to taxpayers not using the APA process, and to the operation of the tax system generally. Finally, Part V uses the APA program case study and the underlying procedural tensions it has produced to illuminate the current administrative law debate regarding the creation and modification of administrative systems and the plausibility of reform through more interactive and collaborative administrative structures.

I. PRESSURES ON THE SYSTEM: TRANSFER PRICING MELTDOWN

The administration of the income tax system operated for more than seventy years before the introduction of APAs, and throughout that period U.S. and foreign businesses engaged in cross border activity. Why then did the Service feel compelled to design an alternative program in the 1990s? The answer lies in the quick rise of large scale international business transactions and the concurrent development of other countries' tax regimes. The international nature of modern business adds stresses to our tax system which it is not fully prepared to handle. One of the most dramatic of these stresses is transfer pricing. Although the tax system has wrestled with transfer pricing issues virtually since the inception of the income tax, the results have never been entirely satisfactory. Failings here were more easily ignored when the volume of transactions was smaller, however, the growing scale of international business has intensified the need for better resolution of transfer pricing. Efforts to improve transfer pricing through changes in the substantive law met with little success. Ultimately, the Service realized that a change in the procedural mechanism for addressing transfer pricing problems might prove the best option. Thus, the Service developed a new procedure for transfer pricing—the APA program.

A. The Transfer Pricing Demon

Transfer pricing and the allocation of an economic unit's¹⁵ profit among its various functions is an issue of fundamental and increasing significance as more income is earned cross border. In a multi-jurisdictional world where tax rules differ, taxpayers have an incentive to structure their related party transactions¹⁶ to locate the entire group's profit or loss in the most desirable taxing jurisdiction.¹⁷ When a taxpayer engages in cross border transactions with related parties, the opportunities to limit or avoid income tax dramatically increase. Because the parties are essentially a single economic unit, the price paid between the two merely splits the income between the two entities, but does not affect the wealth of the unit (tax effects aside). Thus, the two parties can price the transaction (e.g., the sale of goods, services, intellectual property) in a way that puts more income in the entity operating in a lower tax jurisdiction—a strategy of transfer pricing. This objective can be accomplished by pricing the transactions below or above market price. For example, a U.S. company with a foreign distribution subsidiary in a low tax jurisdiction has an incentive to sell its goods to the subsidiary at an artificially low price so that little profit appears in the U.S. parent. When the subsidiary sells the goods to independent third parties at market prices, the subsidiary will have an artificially low cost and an artificially high profit. This profit is taxed to the subsidiary and if the subsidiary is carefully placed in a low-tax jurisdiction then that profit bears little, if any, tax. The group's overall profit is the same and reflects market rate transactions: the difference between the parent's cost of producing the goods and the price the third party finally pays for the goods. However, that difference (the total profit) is artificially split between the parent and subsidiary so as to reduce U.S. income tax due.¹⁸

15. The term "economic unit" here includes a parent corporation and its controlled subsidiaries.

16. Related party transactions refer to those between commonly owned or controlled entities. Classic examples include two subsidiaries owned by a parent, or a parent-subsidiary pair, although the statutory conception of potential "related" parties in the context of transfer pricing is not so narrowly drawn. See Treas. Reg. § 1.482-1(i)(4) (defining controlled to include "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised . . .").

17. See *infra* note 19 for more discussion of where and how profits should be taxed.

18. In some cases, the U.S. tax rules would eliminate the benefit of shifting the profit into the subsidiary by preventing "deferral" of U.S. tax on the income of the U.S. parent's foreign subsidiary. For example, the Code sometimes requires a U.S. parent to include its share of the foreign subsidiary's income on its (the parent's) U.S. tax return in the year earned by the subsidiary, despite the subsidiary's retention of the earnings. See, e.g., I.R.C. § 951 et seq. Such rules are insufficient to stop transfer pricing because they apply only to certain

Although proposals to end deferral entirely are offered from time to time, there are theoretical and practical barriers to this route. Policy decisions in cross border taxation must consider the appropriate goals of the tax rules—particularly in terms of the impact of tax rules on taxpayer behavior. Typically this analysis is framed as a debate about “neutrality”—whether U.S. tax rules should make a U.S. business neutral as between investment inside and outside the United States (capital export neutrality) or whether the tax rules should make a U.S. business equally competitive in the foreign jurisdiction in which it is conducting business and competing (capital import neutrality). Allowing deferral comports with capital import neutrality but not with capital export neutrality. On a more practical level, the political pressure exerted by U.S. multinationals and trade groups (in part under the banner of U.S. competitiveness in the global market place) plays a significant role in what tax regimes Congress likely will adopt.

Transfer pricing strategies are not limited to U.S. taxpayers seeking deferral of U.S. tax. A foreign parent with a U.S. subsidiary would also want to take as much profit out of the U.S. subsidiary as possible and place it in a low-taxed related party. The parties could use the same technique as above if the U.S. subsidiary were the manufacturer/seller and the foreign parent were the buyer. If instead the U.S. subsidiary were the buyer, strategic pricing would have the U.S. company pay an artificially high price to the foreign parent so that when the U.S. subsidiary resold the goods its cost would be artificially high and thus its share of the profit artificially low. Same goal, different steps. Transfer pricing, of course, is not restricted to the sale of goods, but can occur with any related party transaction. Moreover, transfer pricing is not limited to cases involving low tax countries. In any cross border related party transaction, taxpayers have an incentive to assess their relative tax positions in the pertinent jurisdictions and determine where it would be most beneficial to locate the income. Tax rate is a major factor, but unused losses as well as other specials rules can impact the taxpayer’s perspective on a particular jurisdiction.¹⁹

kinds of income earned by the foreign subsidiary. And, of course, they do not (and could not) apply at all to U.S. subsidiaries of foreign parents.

19. To fully appreciate the issue of transfer pricing it may be helpful to outline a little more about how and where profits should be taxed. Basic principles of income taxation shared by most members of the international community include: (1) parties (i.e. related parties) should price their transactions as if they were independent market transactions—the arm’s length concept—so that each taxpayer has the “right” amount of income to report, and (2) that once a taxpayer has properly identified its income, the various countries that might have a claim to tax it must do so based on shared norms as to which country has the priority to tax. Regarding the first point, establishing the proper pricing of related party transactions, there

B. Historical Treatment of Transfer Pricing

The United States historically has combated transfer pricing by requiring the price of the transaction between the related parties to reflect an arm's length relationship.²⁰ The idea is that the related parties should be charging each other the same price they would charge an unrelated party. The mechanism for this rule is the broad statutory language of the I.R.C. § 482 which grants the Service the authority to reallocate income, deductions, and credits between or among related parties where the transactions are not conducted at arm's length prices. Unfortunately, while the problem and the "solution" may be relatively simple to describe, implementation of the statutory response has not been simple because of (1) the lack of information,²¹ (2) the multi jurisdictional element,²² and (3) unsettled questions about the validity of

has been significant debate and change as seen by the history of the I.R.C. § 482 regulations. See *infra* text accompanying notes 20–35. The primary question is how do we know what the arm's length price should be. In a few circumstances there may be direct evidence, such as sales by the taxpayer of the same goods under the same terms to both related and unrelated parties. But in the absence of such direct evidence, efforts have turned to several formulas that do not price by reference to other transactions, but by reference to more general numbers. For example, the regulations can establish a "proper" transfer price by looking at the profit margin or mark up that comparable taxpayers earn in selling similar goods or services to unrelated parties. Assuming that the taxpayer in question should earn approximately the same margin or mark up, then the proper related party price can be calculated by adding that same mark-up to the taxpayer's cost in acquiring the goods.

As to the second point, allocation of income among taxing jurisdictions, a consensus has emerged among most nations and is reflected in the common structure of income tax treaties. The consensus view is based on distinctions between active and passive income, and between source and residence countries: (1) if a taxpayer is actively engaged in business (e.g. manufacturing, or selling goods or services) then the country in which these activities take place (the source country) has the primary right to tax the income; (2) if the source country does not tax the income then the taxpayer's residence country may do so (under U.S. law U.S. corporations have their residence in the United States); (3) if a taxpayer is earning passive income (such as dividends and interest not earned in active business) then the residence country of the taxpayer typically has priority to tax. This last result regarding passive income is usually achieved by treaties in which the source country for the passive income agrees to reduce or eliminate any tax it would have imposed on such income going to the taxpayer. For example, if a U.S. corporation is earning dividends from France, then under the France-U.S. income tax treaty France acknowledges the United States' greater priority to tax this income by reducing the French income tax (usually in the form of a withholding tax) on the income. Of course, the United States agrees to do the same for dividends being paid from the United States to a French resident.

20. Code provisions aimed at deferral also impact the effectiveness of transfer pricing. See *supra* note 18.

21. As an initial matter, many cases lack a comparable sale to a third party to set the arm's length price. Thus, the regulations implementing I.R.C. § 482, outline various methods to approximate or back into the arm's length price. See generally Treas. Reg. § 1.482-1 et seq. Application of even these substitute methods calls for data both contested and often unavailable. See, e.g., *infra* notes 40–42.

22. See *infra* text accompanying notes 30, 31, 35.

the arm's length approach due to possible differences between integrated multinationals and companies that deal primarily with unrelated taxpayers. The track record of transfer pricing regulation and enforcement reveals the difficulty that has existed through the history of I.R.C. § 482.²³ However, as the issue has become more important and the volume of related party international trade has expanded, the holes in the system have grown very serious.

By the 1960's, the government became increasingly concerned that U.S. corporations were achieving a significant amount of deferral of U.S. tax through transfer pricing strategies with affiliates in low or no tax jurisdictions, and that the foreign corporations were effectively shifting profits out of their U.S. affiliates.²⁴ Thus, the United States issued transfer pricing regulations in 1968,²⁵ establishing specific rules for reaching arm's length results in different types of transactions.²⁶ Despite the hope that these regulations would adequately equip the Service (and the courts) with the tools necessary to resolve transfer pricing cases, it became increasingly apparent during the 1970s and 1980s that the arm's length standard did not work in many cases: it was hard to find the "right price" and hard to draft regulations to identify that price with minimal conflict between the taxpayer and government.²⁷

In the 1980s, the focus on transfer pricing abuse turned to foreign-owned companies using transfer pricing to move profits out of the United States.²⁸ The concern was that foreign-owned companies operating within the United States were paying disproportionately low

23. See, e.g., Reuven S. Avi-Yonah, *The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89, 95 (1995); see also Notice 88-23, 1988-2 C.B. 458 (the "White Paper"); *Eli Lilly & Co. v. Comm'r*, 84 T.C. 96, 114-15 (1985). Although some version of the provision has been in the Code since 1917, the Service first issued regulations in 1935 detailing more specifically how the clear reflection of income and determination of true tax liability was to be achieved. See Avi-Yonah, *supra* note 23, at 97.

24. See Avi-Yonah, *supra* note 23, at 100 (citing hearings on the President's 1961 Tax Recommendations Before the Committee on Ways and Means, 87th Cong., 1st Sess., Vol. 4 at 3549 (1961)); Stanley Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625, 643-44 (Feb. 17, 1986).

25. T.D. 6952, 1968-1 C.B. 218.

26. *Id.*

27. See, e.g., Avi-Yonah, *supra* note 23, at 112.

28. See, e.g., Barbara McLennan, *Responses to Section 482 Litigation: Advance Pricing Agreements or Arbitration?*, 54 TAX NOTES 431, 431 (Jan. 27, 1992) (noting the "Pickle" hearings conducted in 1990, which explored whether foreign controlled companies operating in the United States were complying with U.S. tax law; and also noting then-Commissioner Fred T. Goldberg, Jr.'s 1986 statement that foreign owned companies had \$550 billion in gross sales and negative taxable income of \$1.5 billion which lead then-Commissioner Goldberg to call for more creative approaches for resolving transfer pricing cases).

U.S. income taxes compared to similar U.S.-owned companies.²⁹ With respect to both U.S. and foreign owned multinationals, the growing magnitude of the transfer pricing problem and the difficulties policing it were due to a number of factors: (1) the increase in cross border transactions generally,³⁰ (2) the increase in foreign investment in the United States,³¹ (3) the level of complication in transfer pricing audits (because of their fact intensive nature),³² (4) the difficulty in settling transfer pricing cases because of the size of the adjustments at issue,³³ (5) the burden of transfer pricing cases on the Service and courts,³⁴ and (6) the increased likelihood of double taxation following other countries' growing interest in transfer pricing issues.³⁵

29. See, e.g., George N. Carlson, Cym M. Lowell, Rom P. Watson, *Transfer Pricing for Goods, Services, and Intangibles*, C693 ALI-ABA 117, at 182-84 (quoting Chairman of the House Oversight Committee at the outset of hearings on the role that transfer pricing plays in the apparently low effective tax rates paid to the United States by foreign multinationals doing business in the United States); see also *NONPAYMENT OF TAX*, *supra* note 7, at 3, 7-8.

30. See, e.g., McLennan, *supra* note 28, at 431.

31. See, e.g., *id.*

32. See, e.g., *NONPAYMENT OF TAX*, *supra* note 7, at 33 ("The data requirements and the subjective nature of the pricing methods imposed a significant administrative burden on both corporate taxpayers and IRS, and also led to uncertainties for corporations about their ultimate tax liabilities."); *Tax Judge Predicts Procedural Changes to Adapt to Transfer Pricing Globalization*, 114 DAILY TAX REP. G-7 (June 13, 1997) (citing U.S. Tax Court Judge David Laro's assessment that transfer pricing cases might require court appointed experts because of their complexity).

33. See generally George Guttman, *IRS Averages: Winning Little, Losing Big*, 93 TAX NOTES INT'L 197-2 (Oct. 11, 1993) (observing that the Service is often unwilling to settle cases after it has invested substantial resources).

34. See, e.g., *NONPAYMENT OF TAX*, *supra* note 7, at 6 (for cases closed in fiscal year 1993 and the first half of fiscal year 1994, the Service spent 1/3 of its total international examiner time and much more of its economists time on cases with an I.R.C. § 482 issue). *U.S. Treasury and IRS Report on the Application and Administration of Section 482* (April 9, 1992) reprinted in *Daily Tax Report* (BNA) No. 70, at S-34 (April 10, 1992). ("For the foreseeable future, transfer pricing litigation will place a heavy burden on the Service and Tax Court."). As an indication of the potential volume of information in transfer pricing cases it is interesting to note that Chevron produced at least 650 boxes of documents for the Service in the course of its transfer pricing litigation. See Jim Fuller, *U.S. Tax Review*, 93 TAX NOTES INT'L 205-10 (Oct. 25, 1993).

35. See generally *Taxpayers Must Show Substantial Evidence to Back Resale Pricing Methods*, IRS Says, 242 DAILY TAX REP. G-4, G-5 (Dec. 20, 1993) (IRS Chief, Tax Treaty Division reporting that "[i]n bilateral transfer pricing issues . . . [the] IRS has seen increasing requests by U.S. treaty partners to get information and even to participate throughout the whole process"). This interest in transfer pricing gradually manifests itself through the enactment and/or revision of transfer pricing regimes in various countries. See, e.g., J. Scott Wilkie, *New Rules For an Old Game: A Transfer Pricing Update Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report 42:1, 42:23-42:25 (1995) (describing Canada's introduction of transfer pricing penalty provisions as a response to the potential threat on the Canadian tax base posed by strong U.S. transfer pricing penalties); Alan Shapiro, Bill Dodge, et al., *Three Downs and Out: New Canadian Transfer Pricing Rules Level the Playing Field*, 15 TAX NOTES INT'L 1623 (1997) (outlining the motivation

C. Service's Unsatisfactory Responses to the Explosion in Transfer Pricing

In the face of these developments, the Service pursued a series of transfer pricing cases against taxpayers, but failed to win major cases.³⁶ Nonetheless, the Service continued to audit and litigate, and the volume of transfer pricing cases in the courts exploded.³⁷ As part of a continuing effort to improve this situation, new transfer pricing regulations were finalized in 1994.³⁸

On the positive side, the 1994 regulations addressed a variety of observations that emerged from the years of pricing controversy, such as the relative uniqueness of many business operations, the complexity of determining an arm's length price, and the difficulties raised by the transfer of intangibles.³⁹ Unfortunately, the very reference to a concept of an artificially high transfer price implies knowing the correct price. In reality, rarely is the "correct" price clear and obvious. If a comparable uncontrolled⁴⁰ sale exists, then identification of the proper price may be straightforward. But many related-party transactions do not have arm's length comparables, either because such transactions are not taking place among unrelated parties, or because the information is not available.⁴¹ In

behind the revised Canadian transfer pricing rules issued in 1997); Allan O. Taylor, *Transfer Pricing: Fundamental Change in the United Kingdom*, 6 TAX MGMT. TRANSFER PRICING REPORT (BNA) 545 (Nov. 12, 1997) (extensive proposed reforms for the U.K. transfer pricing system including the introduction of "self-assessment" for companies); *IRD to Issue Revised Guidelines Draft Soon, Will Likely Launch Formal APA Program in '98*, 6 TAX MGMT. TRANSFER PRICING REP. (BNA) 385 (Oct. 15, 1997) (New Zealand enacted a transfer pricing regime in December 1995, effective in 1996).

36. See, e.g., Joseph H. Guttentag & Toshio Miyatake, *Transfer Pricing: U.S. and Japanese Views*, 8 TAX NOTES INT'L 375, 385 n.57 (noting that five corporations had major transfer pricing cases during the period 1990-92 and that the United States lost a significant I.R.C. § 482 issue in each); see also *IRS Loses Another Transfer Pricing Case*, 80 J. TAX'N 308, 308 (1994) (the Tax Court's rejection of most of the Service's income and expense reallocations in *Seagate Technologies, Inc. v. Commissioner*, 102 T.C. 149 (1994) represents the third major transfer pricing loss for the Service in recent months).

37. See, e.g., Arthur L. Nims, III, *Tax Court Management of Jumbo Cases: The New Challenge*, 38 FED. B. NEWS & J. 330, 330 (1991) (transfer pricing has become the new "growth" area for Tax Court litigation and such cases represent "massive undertakings").

38. InterCompany Transfer Pricing Regulations, 59 Fed. Reg. 34971, 34990 (1994) (T.D. 8552) (to be codified at 26 C.F.R. pt. 1.602).

39. See, e.g., Treas. Reg. § 1.482-1(c) (describing the "best method rule"); see *id.* at § 1.482-4 (method for determining taxable income regarding transfer of intangible property), see *id.* at § 1.482-5 (outlining comparable profits method which is based on operating profit margins rather than individual transactions).

40. "Uncontrolled," i.e., a similar transaction or sale with a third party.

41. See NONPAYMENT OF TAX, *supra* note 7, at 33 ("A major obstacle in enforcing the arm's length standard has been the difficulty that the IRS examiners have had in finding readily identifiable comparable transactions."); *Rolls Royce Executive Discusses Company's Path to U.S. APA Agreement*, 7 TAX MGMT. TRANSFER PRICING REP. 180 (July 15, 1998)

such cases, the methods used to determine the disputed price are at best one step removed. The 1994 regulations acknowledge this challenge by specifying additional approaches intended to respond to these more difficult situations.⁴²

The new regulations did not, and were not expected to, eliminate transfer pricing controversies because the rules continued to be complex and the debates intensely factual. The cross border element further compounded the domestic difficulties in developing a straightforward approach for related party pricing. If the United States reallocates income under I.R.C. § 482 away from a foreign party and to its related domestic party, then the foreign party has less income and presumably will pay less tax in its home jurisdiction. Of course, nothing binds the foreign country to the U.S. view of the proper pricing and resulting income division. In fact, it would not be unlikely for the foreign country to disagree and view the income as earned by the foreign party. The result could be both countries taxing the income—unrelieved double taxation. As a practical matter, there are mechanisms to resolve this kind of dispute, but they are not always successful, nor are they costless or quick.⁴³ Moreover, some foreign countries view the U.S.'s "aggressive"

[hereinafter "Rolls Royce"] (noting third party comparables are extremely rare and tend to involve one-time only sales). Similarly, taxpayers can have difficulty getting useful information about other businesses, especially competitors. Moreover, there are suggestions that direct acquisition by a taxpayer of its competitor's pricing data could raise antitrust issues. See Dale W. Wickham & Charles J. Kerester, *New Directions Needed for Solution of International Transfer Pricing Puzzle: Internationally Agreed Rules or Tax Warfare*, 56 TAX NOTES 339, 352 (July 20, 1992).

42. For example, the new regulations specifically outlined the profit split and comparable profits methods for identifying appropriate prices/ranges of prices in the absence of transaction specific data. Treas. Reg. §§ 1.482-6. See also NONPAYMENT OF TAX, *supra* note 7, at 2-3 (noting impact of the regulations). Underlying the more factual or "technical" problems of establishing prices in the absence of similar transactions between unrelated parties, continues an intellectual debate as to how to handle the fact that multinationals may in fact be different from their unintegrated counterparts that deal only with third parties. Should arm's length pricing really be the model for related party transactions if, in fact, multinationals operate differently and operate as an integrated group precisely because they gain various advantages, efficiencies and controls by dealing primarily with related parties. A less philosophical, and more concrete manifestation of this question is how to allocate the transactional savings of related party dealings, especially in the more formulaic area of the I.R.C. § 482 regulations (the comparable profits method and the profit split method).

43. Income tax treaties contain competent authority provisions to handle situations of double taxation but they do not guarantee agreement, nor are they necessarily speedy. See, e.g., Christine Halphen & Ronald Bordeaux, *International Issue Resolution Through Competent Authority Process*, 64 TAX NOTES 657, 661 (Aug. 1, 1994) (noting that competent authority process has been criticized for its slow pace—and that in 1990 the average processing time was 3.5 years, although its has been significantly reduced); Elizabeth Schwinn, *IRS Gets a New Look, New Audit Approach in 1999; Prospects Good for New Transfer Pricing Regulatory Projects*, 7 TAX MGMT. TRANSFER PRICING REPORT 716, 716-17 (Jan. 27, 1999) (noting that in 1998 the percentage of taxpayers receiving full relief from

position on transfer pricing as pressuring taxpayers to price their related party transactions to favor the U.S. fisc so that such taxpayers can minimize costly conflict with the United States.⁴⁴

Even before the new regulations were finalized in 1994, the Service recognized that it faced a renewed transfer pricing challenge which involved high stakes and a serious burden on the tax system. The Service sought multiple remedies. To the extent the problem derived from the difficulty in reducing transfer pricing concepts to workable rules, substantive law reform efforts would likely have limited success (as was ultimately seen with the 1994 regulations). The Service recognized that the burdens on the tax system from transfer pricing disputes also resulted from the nonsubstantive factors noted above, including the role of other countries, the significance of factual/legal determinations, and the high dollars at stake with its corresponding impact on taxpayer-Service negotiations.⁴⁵ For these reasons, the Service pursued procedural reform to improve the resolution of transfer pricing issues. The new procedural approach introduced was the APA program. As a procedural response, the APA program essentially accepts the existing substantive law baseline, although the program anticipates an interactive effect on the underlying tax law. Thus, the core issues raised by the innovation arise much less from the substantive tax rules than from the administrative and systemic implications of this alternative procedure. The focus, therefore, shifts to the exploration of the administrative and procedural issues—first in the immediate context of the APA program and its direct mission. Then, the analysis moves to the level of administrative design generally where links to broader administrative and regulatory debate inform concrete arguments regarding the APA program.

double taxation fell to 87%). "Competent Authority" is a tax treaty term that refers to the governmental group or division in each treaty country that is responsible for negotiating with the other country to resolve conflicts under the treaty.

44. See, e.g., Wilkie, *supra* note 35, at 42:23–42:25 (Canada viewed U.S. transfer pricing penalty provisions as encouraging multinationals to overstate U.S. income, correspondingly understating income taxable in other countries, such as Canada). Cf. Marc Levey and Pierre-Sebastien Thill, *Transfer Pricing in France Moves Closer to U.S. Approach*, 7 J. INT'L TAX'N 388, 396 (Sept. 1996) (noting that as regards U.S. and French approaches to transfer pricing, "true parity still may not exist either in the technical reading of the rules or the manner of enforcement. . . [and that] [o]nly time, actual reported experiences, and possibly an active participation in the APA program can truly identify these gaps and indicate how to bridge them.")

45. See *supra* text accompanying notes 30–35.

II. INTRODUCTION AND USE OF THE ADVANCED PRICING AGREEMENT PROGRAM

A. Overview

In 1990, the Service announced the planned introduction of a new procedure which it called Advance Determination Rulings.⁴⁶ By the time the program was formally introduced in March 1991,⁴⁷ the name had been changed to the Advance Pricing Agreement Program, which is how it is known today.⁴⁸ Subsequently, in 1996, the Service issued an updated procedure for APAs, Rev. Proc. 96-53, with changes reflecting several years' experience with the program.

What marks APAs as an unusual procedural device in the tax system is the fact that they permit the taxpayer and the government to discuss and resolve substantive tax issues voluntarily, prior to the transactions occurring, and to reach agreement on their tax treatment. At first blush this may not seem unusual; a student of the tax system could identify other existing mechanisms that allow this kind of interaction.⁴⁹ The APA differs because of the precise nature and context of the interaction. Unlike an audit or settlement agreement, the primary function of the APA is to cover future transactions.⁵⁰ Although advance tax rulings exist in the United States (for example letter rulings),⁵¹ APAs are different for several reasons: the agreements involve foreign countries; the issues are intensely factual (and the facts very complex) and require significant negotiation between the government and taxpayer; the agreements can cover a number of years; and the terms of the agreements are

46. See *Full Text of Draft Revenue Procedure on Advance Pricing Rulings*, 2 TAX NOTES INT'L 565 (1990) (reprinting the unpublished draft revenue procedure prepared by the Service).

47. Rev. Proc. 91-22, *supra* note 12, at § 13.

48. It has been suggested that the name was changed because "rulings" are generally the kinds of documents required to be disclosed (with key information redacted), and the Service did not intend to have APAs made public at all. See, e.g., Mike McIntyre, *IRS Affirms Plans for Developing Secret Tax Law on Transfer Pricing*, 3 TAX NOTES INT'L 267, 268 (1991) (arguing that "[t]he Service apparently made the name change in the hope of improving its position in court should its secrecy rule be challenged."). If the agreements were called rulings, that fact might hinder the Service's efforts to keep the agreements secret. *Id.*; see also I.R.C. § 6110 (describing disclosure rules for various categories of documents). Ultimately, in 1999 Congress eliminated any doubt surrounding disclosure of APAs by amending I.R.C. § 6103(b) to classify APAs as nondisclosable return information. See *supra* note 12. This point of secrecy and disclosure is one to which the analysis returns later in Part IV.

49. See *infra* text accompanying notes 56-61.

50. Its role with respect to past years, however, has been expanded and clarified. See Rev. Proc. 96-53, *supra* note 12, at § 3.06.

51. See *supra* text accompanying notes 56-61 for a description of letter rulings.

confidential with no redacted versions released to the public.⁵² These APA characteristics stand in contrast to the operation of the most common advance ruling, the letter ruling. Such rulings, which are primarily legal determinations applied to relatively generic facts, involve only the Service and are published in redacted form.⁵³ The APA program, although clearly distinct from the existing array of procedures available to taxpayers, drew upon domestic and foreign examples to produce a format tailored to the transfer pricing context. The following sections describe the origins of the APA program and the final product.

B. Origins of the APA Process—Existing Domestic and Foreign Models

Once the Service decided to turn to procedural devices as an answer to the transfer pricing dilemma, it was apparent that a variety of administrative procedures already existed.⁵⁴ Although none was ultimately satisfactory for the task, they set the groundwork for the development of the APA process.⁵⁵ For example, with respect to prospective transactions the Service will, at its discretion, grant a letter ruling which is “a written statement issued to a taxpayer or his authorized representative by the National Office that interprets and applies the tax laws to a specific set of facts.”⁵⁶ Typically, the Service will not issue a ruling unless the answer is clear from applying the law to the facts.⁵⁷ For this reason, letter rulings are unavailable for transfer pricing issues.⁵⁸

52. In the course of a lawsuit brought in 1996 by BNA against the Service to force disclosure of APAs, the Service changed its views and announced intended disclosure of APAs. See *infra* note 228 for a discussion of the BNA lawsuit. The Service indicated that it viewed APAs as subject to disclosure under I.R.C. § 6110. See, e.g., Molly Moses, *Judge Allows BNA to Propose Schedule for IRS to Make APAs Publicly Available*, 28 DAILY TAX REPORT G-7 (Feb. 11, 1999); *IRS-Treasury Letter Announcing Intention to Settle BNA APA Lawsuit*, 7 TAX MGMT. TRANSFER PRICING REP. 88 (Jan. 27, 1999) (copy of letter sent to APA participants indicating the Service's intent to disclose APAs under I.R.C. § 6110). However, as noted earlier, Congress responded in December 1999 by statutorily preventing disclosure of APAs. See *supra* note 12.

53. See *infra* note 61.

54. See generally MICHAEL I. SALTZMAN, *IRS PRACTICE AND PROCEDURE* (Warren, Gorham & Lamont 1991) 1-57-1-59 (outlining the Service's interactions with taxpayers that have traditionally extended beyond regulation drafting, audit, and litigation).

55. See H. David Rosenbloom, Charles T. Plambeck, & Craig A. Sharon, *Advance Pricing Agreements*, 95 TAX NOTES INT'L 131-21 (July 10, 1995) (discussing background of APA programs).

56. 26 C.F.R. § 601.201(a)(2) (1999).

57. 26 C.F.R. § 601.201(b)(5) (1999); Rev. Proc. 96-1, 1996-1 I.R.B. 8, § 5.14.

58. See, e.g., Sheryl Stratton, *Competing Interests Snag APA Program Guidance*, 70 TAX NOTES 138, 139 (Jan. 8, 1996) (quoting APA program original director Robert Ackerman, that APAs differ from letter rulings in that an APA is “not truly an interpretation of the law

In the area of transfer pricing, although “literal” facts (e.g., whether the taxpayer sold 10 or 110 widgets to its parent, or whether the taxpayer charged the parent \$300 or \$7,000 may not be in dispute) the legal significance of facts is disputed. For example, because pricing methods often depend on identifying comparables, the parties will argue over what constitutes a “comparable” transaction—What is the relevant market? What is the relevant good or service being sold? How should differences between the taxpayer’s transaction under scrutiny and those identified as possible comparables be adjusted to ensure comparability? In addition, disputes over the appropriate method and its application would ensue. This level of factual/legal dispute is considered unsuitable for the letter ruling context which attempts to provide guidance on the application of law to facts where the facts and their legal significance are relatively straightforward. A National Office letter ruling is binding on the district office in its assessment of a taxpayer’s liability,⁵⁹ but the ruling applies only to the taxpayer who requested it and cannot be cited in other cases by either the Service or taxpayers.⁶⁰ Despite their lack of precedential value, letter rulings are published in redacted form to provide general guidance.⁶¹

For a taxpayer that has completed a transaction but seeks guidance on its tax treatment, the district office may issue a “determination letter”⁶² applying principles and precedents of the National Office to a specific set of facts. Determination letters are not available for questions of an inherently factual nature, thus excluding transfer pricing issues.⁶³ A taxpayer that has been audited and seeks to appeal its proposed adjustment, undertakes settlement discussions with the regional appeals office.⁶⁴ Unlike letter rulings and determination letters, the settlement

the way letter rulings are,” instead an APA “is an application of law to a given set of facts, and those facts are determinative.”).

59. Rev. Proc. 96-1, *supra* note 57. It is not binding on the Service—thus, the Service can revoke or revise a ruling. See, e.g., SALTZMAN, *supra* note 54, at 3–47.

60. I.R.C. § 6110(j)(3) (1999); Rev. Proc. 96-1, *supra* note 57; Rev. Proc. 96-5, 1996-1 C.B. 503.

61. I.R.C. § 6110 (1999) (enacted in 1976). Prior to the Tax Reform Act of 1976, letter rulings were not released to the public.

62. 26 C.F.R. § 601.201(a)(3) (1999). Typically, a determination letter is issued regarding pension plans or exempt organizations. See SALTZMAN, *supra* note 54, at 3–60.

63. 26 C.F.R. § 601.201(e)(2) (1999). Determination letters are published in redacted form. I.R.C. § 6110 (c)(1999).

64. See generally 26 C.F.R. § 601.106(a)(1)(i) (1999). The appeals office serves as the last point of dispute resolution within the Service. See SALTZMAN, *supra* note 54, at 9-9. No appeal can be taken within the Service from a decision at this level; litigation is the only remaining option. The appeals offices generally achieve significant success in settling cases. Appeals resolves “85 percent of the unagreed cases that annually leave the examination process.” Thomas Carter Louthan & Steven C. Wrappe, *Building a Better Dispute Resolution:*

process is available for all tax issues including transfer pricing. However, as discussed in greater detail in Part III, the tax system faces great difficulty in resolving transfer pricing disputes at the appeals level. Although the appeals office's settlement power is enhanced by the ability to take account of the hazards of litigation in reaching an agreement,⁶⁵ several other factors conspire to limit success. The absence of clear, workable rules, the volume of cases, the high dollar amounts at stake and the posture of the issues (and numbers) coming from audit into appeals have, in the case of transfer pricing, made the settlement process less than satisfactory.⁶⁶

In addition to domestic examples of nonlitigative resolution of tax controversies, at least two foreign examples existed as the APA program was being designed, both prompted by transfer pricing.⁶⁷ The first example involved General Motors' reported experience in resolving income allocation disputes in Europe in the 1980s. To reduce tax exposure from such controversy and to reduce the risk of double taxation, General Motors sought written agreements from various

Adapting IRS Procedures to Fit the Dispute, 73 TAX NOTES 849, 850 (1996). The Service has traditionally encouraged resolution of adjustment disagreements through the appeals process rather than court litigation because of the perceived savings to all parties in time and resources. See SALTZMAN *supra* note 54, at 9-2, 9-3.

65. See IRM 8631(2), MT 8-209 (May 19, 1992) (Settlement Objective). A settlement is formally concluded when it is embodied in a settlement agreement. In a nondocketed case, the signed appeals agreement is usually recorded on Forms 870 or 870-AD, which differ in terms of pledges against reopening for further assessment or suing for refund. See SALTZMAN, *supra* note 54, at 9-56. Although these are purely administrative (not statutory) arrangements, and are not absolutely binding, they nonetheless have some finality as binding contracts. See *id.* at 9-57 to 9-60. See generally *Lignos v. United States*, 439 F.2d 1365, 1368 (2d Cir. 1971); *Uinta Livestock Corp. v. United States*, 355 F.2d 761 (10th Cir. 1966); *Joyce v. Gentsch*, 141 F.2d 891 (6th Cir. 1944); *Stair v. United States*, 516 F.2d 560 (2d Cir. 1975); *Elbo Coals, Inc. v. U.S.*, 588 F. Supp. 745 (E.D. Ky. 1984), *aff'd*, 763 F.2d 818 (6th Cir. 1985). Alternatively, a settlement can be reflected in a closing agreement—the only statutorily authorized mechanism for entering into a mutually binding agreement. I.R.C. § 7121 (1976). Due to their finality, however, the use of closing agreements is discouraged by the Service in favor of the basic settlement agreements. SALTZMAN, *supra* note 54, at 9-56 to 9-57; IRM 8815, MT 8-216 (Aug. 5, 1992) (Agreement Used When Taxpayer Requests Greater Finality).

66. An optional mediation procedure introduced by the Service in 1995 (after the start of the APA program) is available for the resolution of factual issues including transfer pricing disputes that are in the appeals administrative process and have not been docketed. Mediation is available only after settlement efforts have failed and is limited by other restrictions. Announcement 95-86, 1995-44, I.R.B. 27 *extended by* Announcement 97-1, 1997-2 I.R.B. 62. Of the nine taxpayers interested in the program and qualified to participate, only two have been successfully mediated. See Tonya M. Scherer, *Alternative Dispute Resolutions in the Federal Tax Arena: The Internal Revenue Service Opens Its Doors to Mediation*, J. DISP. RESOL. 215, 226 (1997).

67. See, e.g., H. David Rosenbloom et al., *supra* note 55 (noting the role of General Motors "rumors" as a background element in the development of the APA concept in the United States).

European countries stating that they would respect General Motors' newly developed pricing model based on the resale price method. Reportedly, 16 of the 17 countries approached entered into unilateral agreements with General Motors.⁶⁸

The second foreign example involved Japan's "preconfirmation system" (PCS) introduced by the Japanese National Tax Administration (NTA) in 1987.⁶⁹ Following the adoption of transfer pricing rules in 1986, Japan established the PCS to provide a mechanism by which taxpayers and the NTA could reach a non-legally-binding agreement on an arm's length price.⁷⁰ The PCS model is useful, but its unilateral approach and its absence of binding results means that it would not address all of the factors that make transfer pricing problematic.

C. The APA Procedure

Ultimately, the global recognition of transfer pricing administrative problems led to informal discussions among various countries and taxpayers, and to the development of the first negotiated pricing agreement⁷¹ involving the United States and Australia.⁷² Under the APA program introduced by Rev. Proc. 91-22, taxpayers initiate the U.S. APA process by requesting an APA from the Office of the Associate Chief Counsel International.⁷³ The request must identify the taxpayer and

68. See Emily E. Eliot, *Apple and GM Tax Chiefs Discuss Their Expectations in Obtaining Advance Pricing Agreements*, 3 TAX NOTES INT'L 373 (1991) (quoting Chief Tax Officer of General Motors, James R. Mogle).

69. See, e.g., Akira Akamatsu, *Japanese Competent Authority Discusses U.S. APA Procedure*, 14 TAX NOTES INT'L 1109 (April 7, 1997); Takashi Kuboi & Yoichi Asakawa, *Partnering in Japan: Form of Entry and Recent Tax Issues*, 13 TAX NOTES INT'L 445, 449 (1996); Rosenbloom et al., *supra* note 55; Guttentag & Miyatake, *supra* note 36.

70. See, e.g., Kuboi & Asakawa, *supra* note 69. The PCS has been available through the NTA as an administrative avenue but, for procedural reasons, has been difficult to use. Accordingly, only a few companies applied for an agreement under the PCS in the initial years. The risk of double taxation, however, has prompted Japan to explore methods for drawing more taxpayers into advance discussion and agreement with the government. Incorporating the PCS into law is hoped to encourage more extensive use of the process. See Gary M. Thomas, *Japan to Revise Transfer Pricing Rules in 1997: An Opportunity for Comment by the Foreign Community?*, 12 TAX NOTES INT'L 2000, 2000 (June 24, 1996).

71. Apple Computer Company's advanced pricing agreement with the United States and Australia was announced by the company in March 1991, shortly after the release of Rev. Proc. 91-22. See, e.g., Eliot, *supra* note 68, at 373.

72. See Rosenbloom et al., *supra* note 55.

73. Rev. Proc. 91-22, *supra* note 12, at §§ 4,6. Although the applicable district office of the Service plays a role in the APA process, the focus is the National Office and competent authority (in the case of bilateral and multilateral APAs). Prior to filing a formal APA request, the taxpayer may request a conference. This "prefiling conference" is an opportunity for the taxpayer to get a sense of the acceptability of its proposed transfer pricing methodology. In addition, the taxpayer can ascertain the level of information that the Service anticipates needing to adequately examine the situation. Not all requests require the same level of factual

all parties to the transactions; describe the business operations and history, the ownership structure, capitalization, financial arrangements, and principal business; provide relevant tax and financial data for the past three years, descriptions of financial accounting methods used as well as differences between tax and financial accounting; and explain the taxpayer's and the government's positions on previous and current audit, appeal, or litigation issues.⁷⁴ The request also must include a detailed description of the transfer pricing method being proposed by the taxpayer and demonstrate this method by applying it to the taxpayer's three prior years' data. To establish and evaluate the proposed transfer pricing methodology, the taxpayer may need to provide party profitability data, functional analyses, economic analyses of the general industry, a list of competitors, and a detailed discussion of comparable transactions.⁷⁵ Regardless of whether an APA is signed or not, factual oral and written representations or submissions made during the APA process may be introduced by either the Service or the taxpayer in any administrative or judicial proceeding.⁷⁶

Finally, the APA request must outline the proposed set of critical assumptions.⁷⁷ These are the objective business and economic criteria that are fundamental to the operation of the proposed transfer pricing methodology—any facts about the taxpayer, industry, or tax regime that would significantly affect the substantive terms of an APA, if such facts changed.⁷⁸ As part of the APA process, the Service may require that the taxpayer provide, at its own expense, an independent expert acceptable to both the Service and the taxpayer (and if necessary the foreign government) to review and opine on the proposed method.⁷⁹

After the request is completed, it is sent to the Chief Counsel (National Office) who coordinates with the district office. These interactions form an interesting facet of the APA process. Normally, taxpayers deal with the local district or regional offices for most of the audit, appeal and litigation of a tax matter. The APA process, however, is handled by the National Office. Thus, the APA process brings new people into the dynamic without removing the district office from the

disclosure and economic or legal analysis. *Id.* at § 4. The prefiling conference can be conducted on an anonymous basis, although if the details offered during the conference are vague enough to protect the taxpayer identity, the anonymity might hamper the taxpayer's ability to get an accurate sense of what the APA process would involve in that case.

74. Rev. Proc. 91-22, *supra* note 12, at § 5.

75. *Id.*

76. *Id.* at §§ 9.03, 9.04.

77. *Id.* at § 5.07.

78. *Id.*

79. *Id.* at § 8.

negotiations. As noted earlier, and discussed in greater depth in Part III, the change in personnel focus from the district to the National Office plays a key role in drawing taxpayers into the APA process.⁸⁰

The Service representatives then meet with the taxpayer, often on a number of occasions, to discuss facts and economic analysis, and to negotiate.⁸¹ If the parties reach agreement and the Service grants the request, an APA can be signed. If the taxpayer seeks to involve a foreign government in the negotiations then (under the procedure's initial format) the Service and the taxpayer first reach agreement with each other and enter into a memorandum of understanding. Then the U.S. competent authority negotiates the issue with the foreign country.⁸² Because such "bilateral" APAs involve competent authorities, generally they are available only when the other country is a treaty party.⁸³ This structure for involving the foreign competent authority in the APA process was one of the key features later changed by the Service.⁸⁴ Negotiating with foreign countries from a locked-in position proved untenable in a program which relied heavily on the foreign countries' voluntary participation.

The incorporation of other countries into the process is often the major appeal of APAs because a pricing agreement between the United States and the taxpayer may be of limited value if the other country (i.e., the country of the foreign related party) takes a very different view of the transaction.⁸⁵ Thus, a bilateral APA can be critical in avoiding double taxation. Although avoidance of double taxation is a primary attraction of the APA program—and some participants may view themselves as merely "stakeholders" who expect to pay a total sum in tax and are indifferent as to how that amount is divided among the relevant jurisdictions—the picture should not be oversimplified. Tax motivations for participating are much more complicated, and the details can take on significance in evaluating the functioning of the program.

80. See *infra* Part III.A.2.b

81. Rev. Proc. 91-22, *supra* note 12, at §§ 6.03, 6.04.

82. See *id.* at §§ 6.02, 6.06, 7.

83. *Id.* at § 7.01. If the agreement reached by the United States and the foreign government is not acceptable to the taxpayer, the taxpayer may withdraw the request and simply execute its APA with only the United States, although this does not guarantee that double taxation will be eliminated. The foreign country might not share the pricing views embodied in the taxpayer's agreement with the United States. *Id.* at § 7.02.

84. See *infra* note 104 for explanation of the change in APA procedure in 1996.

85. In a number of situations, however, a unilateral APA can be appropriate. See, e.g., *Procedures for Bilateral APAs Continuing to Evolve*, 1996 DAILY TAX REP. (BNA) No. 202 at J-2 (Oct. 18, 1996) (then-APA program Director Michael Durst refers to the preference for bilateral APAs, but recognizes that unilateral APAs may be necessary where, for example, they involve a nontreaty country or small international flows).

First, even the classic stakeholder may have an interest in where the tax payment goes. Some have national allegiances which may lead them to prefer a particular recipient. Others may have accounting or regulatory repercussions from the tax treatment that create an incentive.⁸⁶ Second, some taxpayers are drawn to the process because of current audit difficulties. The APA process, with its possibility for rollback application, can be an attractive alternative for dealing with existing and future problems, saving interest, penalties and current dispute costs.⁸⁷ Third, taxpayers in a particular industry may consider the APA program, with its ability to rely on treaty authority, as a useful way to combat serious gaps or irrationalities of current rules. For example, taxpayers engaged in global trading⁸⁸ sought "recognition" of interbranch transactions (to achieve more economic taxation), an outcome not directly possible under the Service's interpretation of the Code but achievable through the APA program.⁸⁹ Also a foreign manufacturer could be ensured that its U.S. subsidiary would not be considered its permanent establishment (and thereby subject to more extensive U.S. income taxation) by building that assumption into the terms of the APA.⁹⁰ Such strategic participation in the APA program is the logical outcome of any system that offers participants choice.

Assuming agreement is reached (either with United States alone, or with a foreign country as well), the APA is binding between the Service and the taxpayer and typically effective for about three years.⁹¹ If the taxpayer complies with the APA terms, then the Service will regard the results obtained from applying the transfer pricing methodology specified in the APA as satisfying the arm's length standard and

86. One of the changes to the APA process introduced after the program had been in operation for several years reduced the role of the taxpayer in the bilateral negotiations. *See infra* note 104. Much of the taxpayer response to this change was quite negative, reflecting real concern on the part of the taxpayer that they could be harmed by being left out of that stage of the process. *See, e.g., Role of Competent Authority Seen Causing Some to Rethink Bilateral APA Approach*, 191 DAILY TAX REP. J-1 (Oct. 2, 1996) (noting complaints about the new role of competent authority before the practice was formalized in Rev. Proc. 96-53).

87. *See infra* note 105.

88. Global trading generally refers to the activities of a corporation such as an investment bank, that has many offices throughout the world that engage in buying and selling securities and financial instruments. Different offices may perform different functions, such as hedging for the entire group or handling a particular set of securities or instruments. Often exchanges may take place between the branches, especially if they operate like independent units. Serious tax problems can arise from the U.S. tax treatment which usually does not recognize these transactions. *See* Diane M. Ring, *Risk-Shifting in the Multinational Corporation: The Incoherence of the U.S. Tax Regime*, 38 B.C.L. REV. 667 (1997).

89. *See infra* text accompanying notes 156-159.

90. *See* *Rolls Royce*, *supra* note 41.

91. *See* Rev. Proc. 91-22, *supra* note 12, at § 9.01.

generally will not contest the application of the methodology to the transactions outlined in the APA.⁹² As part of the APA, the taxpayer is required to file an annual report describing the actual operations of the business for the year and demonstrating compliance with the terms of the agreement.⁹³ In certain cases, compensating adjustments to the calculations for that year might have to be made.⁹⁴ In the event of fraud or malfeasance by the taxpayer with respect to material facts provided or good faith compliance with the terms of the APA, the Service can revoke the APA.⁹⁵

Clearly the APA process requires a taxpayer to provide a significant amount of current data regarding business practices, operations, tax treatment, and other sensitive issues. To reduce taxpayer concern regarding vulnerability to public disclosure, the Service initially took the position that information received or generated by the Service during the APA process related directly to the potential tax liability of the taxpayer under the Code. Thus, the APA itself and related data would be subject to the confidentiality requirements of I.R.C. § 6103. In addition, the Service noted that the information was likely to be commercially sensitive and may be confidential pursuant to any relevant treaty.⁹⁶ Although the Service would not name participants or make specific observations and only provided summary data and statistics on the program, some companies that have participated in the APA process have publicly commented.⁹⁷ As noted later in Part IV, the security offered by the Service's position on disclosure in the APA context was ultimately challenged by freedom of information act requests and a lawsuit seeking redacted versions of APAs.⁹⁸ In January of 1999, in response to the ongoing disclosure lawsuit,⁹⁹ the Service announced a change in its position on the disclosability of APAs. The Service stated

92. *See id.* at § 7.02.

93. *See id.* at § 10.01.

94. *See id.* at § 10.02(1). The example in the revenue procedure indicates that if the APA required the transfer pricing methodology to produce results within a certain range but it failed to do so, compensating adjustments might be made to bring the results within the agreed range.

95. *See id.* at § 10.05(1). Such revocation may be retroactive to the first day of the taxable year the APA was in effect. *See id.* at § 10.05(2). Also, an APA may be canceled by the Service if it determines that there was a misrepresentation or mistake as to a material fact or a lack of good faith in compliance with the APA, but no fraud or malfeasance. *See id.* at § 10.06(1). If an APA is canceled, the cancellation is effective beginning on the first day of the year in which the misrepresentation, misstatement, omission, or noncompliance occurs. *See id.* at § 10.06(3). Finally, if there is a change in critical assumptions, law or treaty, the APA may be revised. *See id.* at § 10.07(1).

96. *See id.* at § 11.

97. *See, e.g., Known U.S. Advance Pricing Agreements*, 7 TAX MGMT. TRANSFER PRICING REP. 482 (Oct. 14, 1998).

98. *See infra* note 228.

99. *See infra* note 228.

its new view that APAs constitute "written determinations" subject to redacted disclosure pursuant to the terms of I.R.C. § 6110.¹⁰⁰ Congress reacted in December 1999 by statutorily protecting the confidentiality of APAs under I.R.C. § 6103(b) and thus preventing disclosure.¹⁰¹

After the experience of several years of operating the APA program, the Service updated the process by issuing Rev. Proc. 96-53.¹⁰² The program remained essentially the same although some key changes were made to reflect the Service's evolving views and experiences. Notable changes included a stated preference for bilateral as opposed to unilateral APAs;¹⁰³ the "decreased" role of the taxpayer in competent authority discussions;¹⁰⁴ the Service's stated preference for rollbacks;¹⁰⁵ more specified coordination of the National Office, district and appeals in the formation of an APA team;¹⁰⁶ elimination of the reference to limited APAs covering only the appropriate transfer pricing methodology and the factual aspects of the transactions at issue;¹⁰⁷ and introduction of a sliding scale user fee.¹⁰⁸

100. See *supra* note 52.

101. See *supra* note 12.

102. Rev. Proc. 96-53, *supra* note 12.

103. *Id.* at § 7.07.

104. Under the prior procedure, the taxpayer and the Service could first enter into a memorandum of understanding ("MOU") outlining their agreed APA negotiations, and then the competent authorities would negotiate. The problem encountered in this approach was that other countries felt as if they were being handed a "done-deal" because the MOU had been reached between the taxpayer and the Service. See, e.g., *Service Releases Letters on U.S. Advance Pricing Agreement Process*, 15 TAX NOTES INT'L 979 (Sept. 29, 1997) (announcing release of a Sept. 8, 1995 letter by John Neighbour of Inland Revenue [U.K.] which suggests that such a format may create difficulties). The new revenue procedure seeks to bring the foreign country into the process prior to an established understanding between the taxpayer and the Service, thereby enhancing flexibility for the competent authority negotiations. Some taxpayers expressed concern over the change in their role in bilateral interactions, in part because of their view that they were not simply stakeholders and that it was not irrelevant which country received how much tax.

105. "Rollbacks" refers to the application of the transfer pricing methodology to prior tax years, which are not covered by the APA. See generally Rev. Proc. 96-53, *supra* note 12, at § 3.06. For taxpayers currently experiencing a difficult or frustrating audit (for the various reasons discussed below in Part III) the APA program, with the prospect of rollback of the APA approach, can be appealing. See *infra* note 113.

106. Rev. Proc. 96-53, *supra* note 12, at § 3.07.

107. Such limited APAs described in Rev. Proc. 91-22, § 3.04 would not address the expected range of results of applying the methodology to the facts. These APAs, known as no-penalty APAs, served to insulate the taxpayers from transfer pricing related penalties. See APAs: *First Section 6662 Penalty-Proof APA Nearly Complete*, *Intel Executive Says*, 1995 DAILY TAX REP. 92 G-1 (May 12, 1995) (announcing that Intel Corporation was preparing to complete the first "penalty-proof" APA that would protect the taxpayer from transfer pricing penalties but would still leave it open to transfer pricing adjustments on the transaction at issue). The removal of the reference to this category of APA leaves open the question as to whether the Service will continue to consider such requests.

108. Rev. Proc. 96-53, *supra* note 12, at § 5.14 (with fees ranging from \$5,000 to \$25,000 based on the taxpayer's gross income or the likely annual value of the transactions at issue).

Throughout the nine years that the APA program has been in place, the pace of completed APAs and APAs in progress has increased.¹⁰⁹ As of December 1999, 230 APAs had been completed.¹¹⁰ The Service had requests pending for an additional 187 APAs, almost seventy-five percent of which were bilateral, in conformity with the Service's expressed preference for such use of the process.¹¹¹

III. EFFECT OF THE APA PROGRAM ON PARTICIPANTS: A PROCEDURAL HYBRID ADDRESSING THE DEMAND FOR ADMINISTRABLE TRANSFER PRICING

The continuing administrative problems with transfer pricing motivated the development of the APA program. These problems can be grouped roughly into two general categories, problems stemming from: (1) uncertainty of rule application, and (2) difficulty of resolving disputes. This Part examines the effect of the program on its participants—whether the procedural changes it introduced were successful in making transfer pricing more administrable. The focus on “administrability” reflects the problem oriented approach taken in designing the program. Change was needed precisely because the current system was not workable. What was sought was reform that would make transfer pricing rules administrable. However, critical examination of the program demands more than a narrow look at this procedural reform and its administrability. Complete assessment of the program's success and impact for both participants (Part III) and nonparticipants (Part IV) reflects the tension among a number of relevant evaluative criteria. In weighing the risks and benefits of tax system reform, attention to broader administrative theory sharpens the choices. Furthermore, for the APA program to serve as a case study in administrative theory and design, it is essential to understand the precise impact of the program and the structural decisions that were

109. In October of 1997, the Service had established another avenue for entry into the APA process—the Early Referral Program. The general purpose of the program is to encourage certain taxpayers to seek an APA early in an audit, where appropriate, to help conserve resources. The referrals are made by the district offices which send the names of possible participants to the APA program. Taxpayers are then contacted by the APA office and if the taxpayers are interested, they may move forward with an APA and transfer pricing issues are dropped from the audit until the APA is complete. See Robert S. Ackerman, *Negotiating Advance Pricing Agreements for Financial Institutions*, 16 TAX NOTES INT'L 1713 (June 1, 1998). See *infra* note 184.

110. See *IRS Reports Completed APAs Reached Record High of 60 During Calendar 1999*, 1995 DAILY TAX REP. 14 G-1 (Jan. 21, 2000) [hereinafter *Record High*].

111. *Id.*

made. Only such an in-depth analysis enables broader generalizations and observations to be offered later.

A. APA Program Changes

The APA program introduced three basic changes to the way the Service and taxpayers interact over transfer pricing. First, the APA program changed the timing of the interactions. Transfer pricing issues were not susceptible to the use of letter rulings,¹¹² so any significant interpretation, discussion, or analysis under the existing system occurred after the transaction. In the APA process, however, the taxpayer and government(s) confront the transfer pricing questions at the outset, before the transactions occur.¹¹³

Second, the APA changed the participants. Traditionally, the initial government participant in a transfer pricing issue is the district office, when it audits the taxpayer. This stage is followed by an internal administrative appeal. Ultimately, if the case fails to be resolved through these channels it moves to court. In any event, the IRS National Office and representatives from the relevant foreign countries are not involved in these early stages.¹¹⁴ The APA, however, brings together all of the potentially interested parties (taxpayer, district office, National Office, foreign government) in the up-front process. Rather than sequential involvement, if any, the APA program facilitates the contemporaneous interaction of the full set of actors ultimately involved in a transfer pricing issue.

Third, the APA changes the mission and "scope of power" of the government in handling the individual taxpayer's transfer pricing problem. In the traditional audit context, the district's authority is constrained in terms of flexibility and creativity. As discussed below, the main government actor in the APA negotiations (the National Office) possesses greater degree of flexibility due to a variety of factors,

112. See *supra* text accompanying notes 56–57.

113. This, of course, is a generalization. Some APAs are motivated by the fact that the taxpayer finds itself in a messy transfer pricing audit and decides to pursue an APA, with the hope it will have retroactive effect. See, e.g., *Complexity of Deals Prevents Uniform Financial Products APAs*, 3 FIN. PRODUCTS REP. 959, 960 (Jan. 2, 1998) (quoting Karl Kellar, then-APA Program Branch Chief, "One of the main reasons that taxpayers do come into the APA program is because they are undergoing an audit and they want to deal with transfer pricing issues that arise. In that way, they can get certainty for both the future and the past in a consistent manner.").

114. Foreign countries may also be conducting audits, but the timing of their administrative process does not necessarily correspond to when the Service is examining the years in question.

including its place in the administrative hierarchy and its reliance on treaty power in reaching certain results with other countries.

The combination of these changes produced a new procedure that was, in critical ways, a hybrid of pieces of the system that existed—some occurring *ex ante* and others *ex post*. In designing an alternative structure to address the transfer pricing problem, the National Office had the flexibility to move beyond the traditional patterns to reorganize interactions with taxpayers and other taxing authorities. Whether and how these changes actually improved administrability can best be ascertained by examining how each change affected the resolution of transfer pricing issues.

1. How the Procedural Changes Impact Uncertainty

Despite the arrival of the new transfer pricing regulations in 1993 and 1994, the rules under I.R.C. § 482 remain too vague to provide many taxpayers with certainty regarding the taxation of their related party transactions. Uncertainty here can be costly and likely to produce disputes for several reasons. First, errors in pricing are quite possible given the spectrum of interpretation in applying the rules and identifying relevant third party data.¹¹⁵ Such errors can be expensive as the range of possible “arm’s length” prices can be quite wide and the potential tax adjustments (including penalties)¹¹⁶ quite significant.¹¹⁷ Because acceptance of an adjustment could be costly, taxpayers have a strong incentive to challenge audit adjustments.

Second, the only forum for obtaining certainty in the existing system is through audit, appeals and potentially litigation.¹¹⁸ The process can

115. See generally *IRS 1992 Annual Report*, Pub. No. 55 (May 1, 1993) reprinted in 93 TAX NOTES TODAY 125–76 (June 14, 1993) (“Transfer pricing is an area of ambiguity for both foreign and domestic corporations”).

116. See generally *Large Companies Reconsidering Opposition to APAs Practitioners Say*, 1993 DAILY TAX REP. (BNA) No. 185, J-1 (Sept. 27, 1993) (suggesting that larger corporations are more willing to consider an APA because of the increased threat of penalties under the new I.R.C. § 6662 rules (covering valuation and misstatement and documentation)).

117. As of September 1992 (and again as of June 1994), proposed adjustments for large (i.e. those with assets of \$100 million or more in year of return) taxpayers’ transfer pricing cases awaiting administrative resolution in appeals or litigation totaled \$14.4 billion. See NONPAYMENT OF TAX, *supra* note 7, at 23.

118. Because these after-the-fact dispute resolution steps offer less to the taxpayer, there is less incentive for the taxpayer to be more forthcoming than strictly required in fair compliance with the law and audit process. In theory one might think that an audit settlement would provide sufficient guidance going forward as to transfer pricing treatment for a given taxpayer. This has not seemed to occur, for several reasons: (1) the issues are very fact intensive and the business conditions change, (2) for new products and transactions, error can carry penalties, (3) audit positions are not binding, and (4) audit is not conducted immediately so there are several years of lag time during which the taxpayer must be filing on this issue

involve substantial transaction costs in terms of lawyer and accountant fees, internal resources, as well as the lost opportunity to modify or change the transaction.¹¹⁹

Although participation in the APA process may not be cheap, it is likely to have lower transaction costs than audit, appeals, and litigation¹²⁰ for a number of reasons: (1) fewer layers; (2) less hostility, resulting in more productive discussions; (3) taxpayer incentive to cooperate combined with Service representatives not focused on high dollar audits; and (4) flexibility derived from parties not yet committed to their positions (in part because the future transactions have yet to occur).

Third, the fact that transfer pricing generally involves cross border transactions means that in addition to domestic uncertainty there is the international uncertainty. The other country in the related party transfer might view the appropriate pricing quite differently and double taxation could result.¹²¹ Again, the price of uncertainty is high, leading taxpayers to consider challenging audit positions of the governments.

Fourth, the Service's continued interest in transfer pricing, combined with other countries' increasing interest, suggests that the opportunities for taxpayers to achieve "no taxation" on their related party transactions, as opposed to double taxation, might be more limited. Thus, the potential upside of taking aggressive pricing positions and playing the audit lottery is diminished.

without additional guidance; by the time guidance is available, facts have probably changed enough so that the taxpayer cannot be certain of the Service's view.

119. See, e.g., *NONPAYMENT OF TAX*, *supra* note 7, at 27-28 (noting that major I.R.C. § 482 cases illustrate that they can be "... extremely expensive for taxpayers and the government by requiring the employment of outside experts, resulting in long drawn out litigation and keeping corporate tax liabilities in an uncertain status for years ..."). The four major I.R.C. § 482 cases highlighted by the GAO 1995 report lasted, on average, 15 years from earliest audit to court resolution. *Id.* at 27.

One central problem with the existing mechanisms for resolving transfer pricing issues is that they occur after the transaction. For example, transfer pricing issues typically arise on audit, a number of years after the transaction has been completed and the returns have been filed. Such ex post mechanisms offer certainty, but it is too late to change the transactions for the years under audit (or the years filed but not yet audited), and the audit process does not provide a guarantee as to treatment of future transactions. Similarly, in cases of potential double taxation, conflicting assessments of the related party transactions typically are not addressed until well after they take place, and even that discussion (conducted through the treaty competent authority process) can be long in producing results. See *supra* note 43.

120. If a taxpayer did not anticipate being audited, or if audited, did not anticipate a serious likelihood of these issues being raised, then the comparison of costs might weigh against pursuing an APA.

121. Cf., *Canadian Telecommunications Firm Touts APA's*, 1997 DAILY TAX REP. 230 G-3 (Dec. 1, 1997) [hereinafter "Canadian Telecommunications"] (noting that the combination of significant cross border transactions combined with the risk of serious transfer pricing penalties in the United States and Canada made APAs the right decision for that taxpayer).

A number of features in the APA program directly impact certainty for the taxpayer. The basic structure of the program, as a mechanism to obtain a binding agreement governing the treatment of a specified group of future transactions, directly responds to the need for clear projections.¹²² The inclusion of foreign governments in bilateral and multilateral APAs offers the potential for real certainty—the kind that is only possible if all the relevant players are involved. As discussed below, the flexibility possible in negotiating an APA (due in part to National Office's treaty authority, its position relative to the district, and the fresh start aspect of the relations)¹²³ makes it more realistic for the parties to reach a mutually acceptable application of the transfer pricing rules. Finally, to the extent the APA process may lay the groundwork for changes or developments in transfer pricing rules, a taxpayer's participation in the process affords the possibility of influencing the direction of such changes and thereby increasing certainty and reducing future conflict.¹²⁴

Moreover, having the APA discussion in advance may enable a taxpayer to shape the transfer pricing rules it faces. Where a current rule is very unclear, or in the extreme, prohibits a desired result, the taxpayer's ability to discuss and negotiate on the point before it decides to engage in the transaction is very much like negotiating with the Service for a particular rule to be applied prospectively. This differs from after-the-fact dispute resolution. If a taxpayer engages in a transaction and then seeks a particular treatment in audit, the taxpayer may or may not receive the desired result. Hence the taxpayer will be forced to treat the transaction in an undesired manner without the opportunity to "undo" the transaction. In this way, although settlements and litigated cases produce rules, their impact is significantly different than if the same results had been reached prior to the transaction's occurrence because the taxpayer bears the risk of losing.

Based on this review, the APA changes seem effective in providing certainty.¹²⁵ Two caveats, however, must be noted that limit this effect.

122. See, e.g., *Lawyer Says Taxpayer Sought APA to Avoid Dispute Over Brand's Overseas Value*, 6 TAX MGMT. TRANSFER PRICING SPECIAL REP. (BNA) 205 (July 30, 1997) (uncertainty over possible Service views on the brand name development in Asia led taxpayer to conclude an APA).

123. See *infra* Part III.A.2.c for a more detailed discussion of the impact of the National Office authority and flexibility in resolving transfer pricing issues.

124. For example, the Service's experiences with APAs involving global trading paved the way for the proposed global dealing regulations. See *infra* Part IV.C.2.

125. See, e.g., *Canadian Telecommunications*, *supra* note 121 (taxpayer telecommunication firm's corporate tax director outlined certainty and resource savings as advantages of APAs over audits).

First, the taxpayer's interaction with the government on transfer pricing in the APA process is not the final step. The taxpayer generally will also face an audit as to compliance with the terms of the APA. At the present time it is unclear whether taxpayers with APAs will have easy audits on the covered transactions. If district/taxpayer relations are strained, or if the district did not share in the views reflected in the agreement, the scrutiny of transfer pricing, even with an APA, may remain a sticky process.¹²⁶

Subsequent audits raise another issue about the effectiveness of APAs. The removal of the transfer pricing issue from the audit plate might also encourage Service auditors to spend this time they have saved looking at other issues, especially if the taxpayer is a large multinational. If so, was the APA worth the effort? This question cannot be answered until enough APA years have come up for audit. However, even if the observation regarding auditors' time allocations is correct, that does not mean the taxpayer does not benefit from the resolution of the transfer pricing issues. Transfer pricing, as discussed earlier, can involve large numbers, great variations, and significant penalties. Once identified it often can be challenging to resolve. Although audits are never easy, many other issues that could be raised might be less contentious and less costly to contest or accept.

The second caveat recognizes that the greatest certainty comes from the participation of both the United States and the other relevant taxing jurisdictions. However, these other jurisdictions cannot be forced to participate. Initially, some countries were not very receptive to the new procedure, but gradually more countries have either implemented their own "APA" programs or are considering the possibility.¹²⁷ Still others have indicated a willingness to engage in the APA process for certain

126. Cf. *APA Early Referral Program Attracts First Taxpayer*, Director Barrett Reports, 21 DAILY TAX REP. (BNA) No. 21, at G-4 (Feb. 2, 1998) ("Several practitioners have complained that they had experiences in which the field refused to roll back an APA.").

127. See, e.g., *A Global Review of Advance Pricing Agreements*, 7 TAX MGMT. TRANSFER PRICING SPECIAL REP. (BNA) No. 31 (Jan. 27, 1999) (review of APA programs in 14 countries); *U.K. Tax Official Outlines Scope, Goals of Formal APA Program*, 1999 DAILY TAX REP. (BNA) No. 1, G-2 (Jan. 4, 1999) (U.K. releases draft APA program legislation); see also *Ernst & Young Transfer Pricing 1997 Global Survey*, 15 TAX NOTES INT'L 761, 771 (Sept. 8, 1997); *Australia Issues Final APA Rules Similar to U.S. Requirements*, 22 TAX PLANNING INT'L REV. (BNA) 16 (1995) (Australian Tax Office issued final APA procedures "that substantially mirror" the U.S. program); *IRD to Issue Revised Guidelines Draft Soon; Will Likely Launch Formal APA Program in '98*, 6 TAX MGMT. TRANSFER PRICING REP. (BNA) 385 (Oct. 15, 1997) (New Zealand likely to introduce APA program in early 1998); *Geralyn M. Fallon, Advance Pricing Agreements*, 75 TAXES 304, 306 nn. 8, 10 (June 1, 1997) (Canada introduced its own APA procedure in 1993, and the Netherlands in 1994).

industries (e.g., global trading).¹²⁸ Nonetheless, the APA program's changes to the resolution of transfer pricing questions added increasing certainty for taxpayers in the process. This success, however, depends on the multiple changes described involving timing, participation and scope of authority.

2. How the Procedural Changes Impact Difficulty in Dispute Resolution

In addition to eliminating issues of uncertainty, the APA program's procedural innovations also sought to conquer the core obstacles to improved dispute resolution.

a. Limited Information

Part of the difficulty with transfer pricing rules is that both the taxpayer and government lack sufficient information. The government does not fully understand each industry and transaction, so the regulations, although detailed, do not offer significant guidance on the application of these concepts in specific circumstances. Audits do provide the Service with more information on transactions and markets, but the adversarial context and the lack of incentive for taxpayers to volunteer information not literally required limits this avenue of information acquisition.¹²⁹ Similarly, taxpayers lack information on the government's use of methods, views on comparables, and actual practice in applying the transfer pricing methodologies. Finally, other countries, perhaps in some cases because of lack of information, have been inclined to view the United States' strong emphasis on transfer pricing as unduly aggressive,¹³⁰ arguing that transfer pricing is essentially the allocation of a limited pie.¹³¹ The situation may be exacerbated by regulations involving complex methodologies, the real impact of which can only be appreciated through case-specific application.

128. See, e.g., Fallon, *supra* note 127, at 311 (Germany expressed willingness to consider global trading and financial instrument APAs). See *supra* note 88 for a description of global trading.

129. In some sense the APA program could be viewed like the mediation introduced into the tax system in Announcement 95-86, because both are seeking a format that encourages taxpayers to come forward with more information. See, e.g., Alexei P. Mostovoi, *Tax Mediation: Is It Just a Test*, 13 TAX NOTES INT'L 1871, 1875 (Dec. 2, 1996) (discussing taxpayer incentives and willingness to disclose information in mediation).

130. See, e.g., *U.S.-French APA Could Be Completed Under Tax Treaty*, 1994 DAILY TAX REP. (BNA) No. 127, at G-3 (July 6, 1994) (OECD representative observed that some countries were wary about the U.S. APA process because the United States has "more experience, resources and aggressive rules.").

131. See, e.g., *id.* (French ministry official suggests that they believe the United States is using APAs to "get a larger share of the tax cake.").

The changes brought by the APA program improve the flow of information.¹³² The voluntary nature of the program (with the carrot of up-front resolution and certainty) demands more extensive disclosures from the taxpayer than would a traditional audit, and thus provides the Service with a better picture of how various businesses, industries, and transactions are conducted. The veracity of the disclosures is secondarily guaranteed by the fact that material misstatements or omissions later discovered by the Service can invalidate the agreement. The Service also gathers more information on how variations in methodologies play out; it can require trial tests with taxpayers and get detailed data and feedback. Information generated in this fashion may result in more useful formulations of transfer pricing rules. Foreign countries may find that their participation in the APA process, with the joint case-specific analyses, gives them the opportunity to better understand U.S. transfer pricing approaches and may mitigate their hostilities or concerns.¹³³

For the taxpayer, the informational benefit from the APA relates closely to the certainty obtained through the process. Taxpayers are repeat players only in a limited sense. They might renew an expired APA, or return with additional transactions or related parties, but what they really want to know is how transfer pricing applies to them. The Service, on the other hand, is a repeat player that not only seeks to resolve the case at hand, but also to improve the system. The resolution of an individual case means more than just one less contentious, unpredictable audit down the line. It means more potential insight into transfer pricing treatments.¹³⁴

The APA's role in enhancing information could be viewed as temporary, in whole or in part. For example, if the Service ultimately found its APA experiences sufficiently informative, it could conceivably produce a new set of regulations that offers more guidance to the taxpayer. In that scenario, individual case by case analysis would be

132. See Michael C. Durst *Additional Structure, Growth Characterize IRS Advance Pricing Agreement Program's Past Year*, 6 TAX MGMT. TRANSFER PRICING SPECIAL REP. (BNA) 2, 4 (Oct. 29, 1997) (suggesting that because the APA program gives the Service earlier "hands-on" experience with particular rules and problems, it "can provide uniquely valuable lessons for use in drafting and refining transfer pricing regulations and revenue rulings.").

133. The value of the APA process in this regard might be inferred from the decision of a number of countries to implement their own internal "APA-like" procedure. See generally *U.K. Tax Official Outlines Scope, Goals of Formal APA Program*, *supra* note 127, at G-2.

134. For example, on March 6, 1998, the Service released proposed regulations regarding the taxation of "global dealing," which were developed in part through the benefit of the APA experience with taxpayers engaged in global trading. *Allocation and Sourcing of Income and Deductions Among Taxpayers Engaged In a Global Dealing Operation*, 63 Fed. Reg. 11, 177 (1998). See *supra* note 88 for a description of global trading.

necessary until the Service developed an adequate understanding of business practices and the impact of transfer pricing income reallocations. If the new penalty regulations and documentation requirements make taxpayers less aggressive, that change, in conjunction with improved guidance from the Service, could reduce the volume of transfer pricing audits and cases.

Alternatively, the informational role of the program could be permanent vis-a-vis transfer pricing generally, but temporary as regards particular issues or problems. For example, after sufficient exposure to a particular industry or transaction, the Service could provide a detailed description of how it approaches the arm's length standard in such cases, as done in Notice 94-40 and the global dealing regulations addressing transfer pricing. The scope of this informational role is considered again in Part IV in connection with the impact of the APA program on nonparticipants.

b. Hostility Between Taxpayer and Agent

The state of taxpayer government relations has impeded resolution of transfer pricing issues which require cooperation and exchange of information. The APA program makes several changes in personnel (the who and what authority of the government) that impact the various relationship problems experienced in transfer pricing.

In the traditional tax dispute path, the first step is audit, which involves the taxpayer and the district office. Resolution at this stage can be hampered for several reasons related to the participants. The district office (agent/audit team) is the level of the Service in constant contact with the taxpayer (especially in the case of larger taxpayers, where there may be "permanent" on-site examiners in what can be an adversarial relationship). Frictions can develop that are exacerbated by this constant interaction. Once the taxpayer has come to view the agent/district level as hostile and unreasonable, and the agent/district has come to view the taxpayer as aggressive, deceptive and uncooperative,¹³⁵ the chance for successful negotiation and resolution of complex issues is limited.¹³⁶ The

135. See, e.g., Eliot, *supra* note 68. Although rotation of auditors might ameliorate some of the direct taxpayer-agent difficulties, there potentially is a serious learning curve issue. Continued familiarity with a taxpayer, its industry and its reporting history can allow an agent to develop an informed picture of a taxpayer.

136. See generally Lyons *Sees APA Requests Accounting for Half of Competent Authority's Case Load*, 5 TAX MGMT. TRANSFER PRICING REP. (BNA) 429, 429-30 (Nov. 27, 1996) (IRS Assistant Commissioner (International) observing that, for example, the district and competent authority are "two very different institutions" with different objectives—with the field's role being more adversarial as compared to competent authority's more "settlement oriented" role); Scott Shaughnessy, *U.S. APA Program Offers 'One-Stop Shopping'*, 11 TAX

appeals office, though distinct from the district audit function and personnel,¹³⁷ still can have difficulty resolving transfer pricing issues emerging from the audit. Often the posture of the issue, including the size of the adjustment, the gap in the parties' numbers and the recalcitrance of the participants at that point inhibits settlement at the appeals level.¹³⁸

The APA involves the National Office in the discussion at the outset. This new participant not only acts on its own views and authority, but it can also help mediate the views of the taxpayer and district. In part, the National Office is able to do this because of the absence of an intense one-on-one history with the taxpayer. Plus, its role in the process begins before positions have become entrenched (a problem experienced by appeals). In fact, where the focus is future transactions, not only are positions not yet fixed, the actual subject matter has yet to occur.¹³⁹ As a result, the APA process attracts taxpayers by granting the opportunity to sidestep or modify an unproductive relationship at the district level and obtain a bit of a "fresh start."¹⁴⁰

This impact of the APA process is borne out by comments of an early APA participant. Immediately following the release of Rev. Proc. 91-22, Apple Computer Co. ("Apple") announced that it had completed an APA regarding the sale of products to an Australian distribution

NOTES INT'L 402, 403-04 (1995) (noting view of some practitioners that the field agents are typically "more revenue-oriented than National Office [and] tend to be more exacting on taxpayers with whom they have greater familiarity.").

137. See, e.g., Halphen & Bordeaux, *supra* note 43, at 662 ("Traditionally, each IRS function has a strictly defined role: the Examination function [audit] is responsible for identifying an audit issue and developing supporting facts and methods; Appeals is responsible for exploring the range of a reasonable settlement given the strengths and weaknesses of the case and hazards of litigation.").

138. See, e.g., Steven C. Wrappe, *Advance Pricing Agreements: The IRS Rediscovered Alternative Dispute Resolution*, 8 TAX NOTES INT'L 1581, 1585-86 (1994) ("Sometimes a large adjustment in the Notice (of Deficiency) assumes a life of its own and, regardless of the merits, it becomes difficult for anyone at subsequent stages to take responsibility for 'giving up' a substantial proposed deficiency." (quoting Thomas C. Durham)).

139. In substantively reaching the APAs, the up-front nature of the discussion enhances the flexibility of the parties' positions because an in-hand dollar amount is not being surrendered. See generally Durst, *supra* note 132, at 2 (noting that the up-front nature of the APA process enhances the parties' flexibility in part because they still have the option to change their business decisions). To the extent taxpayers gain by certainty, they are more willing, as part of the process, to reveal more information to the government, which in turn provides the government a more informed foundation on which to contemplate modifications and changes to transfer pricing.

140. See, e.g., Shaughnessy, *supra* note 136 (quoting Deputy Associate Chief Counsel International Benedetta Kissel that the "non-adversarial approach is at the core of the APA Program."); Durst, *supra* note 132, at 3 (APAs are useful for "resolv[ing] an especially contentious examination history (or the IRS field examiners may suggest to the taxpayer that the program be used in this manner)").

subsidiary.¹⁴¹ According to Apple, the APA process was preferable to the typical audit experience in which the Service selected only particular related party transactions for adjustment—those that should be adjusted in the U.S. favor. In addition, Apple expressed satisfaction with the central role of the National Office in APAs, characterizing interactions with “these higher level IRS personnel” as much better than those with the “more antagonistic auditors.”¹⁴² Another taxpayer, Hitachi Metals America, turned to the APA program after its second “very contentious audit”—Hitachi had been frustrated by the district’s “unnecessary” information requests, its factual positions, its large proposed adjustments and its apparent interest in “horse trading.”¹⁴³

Although the personnel changes improved the government-taxpayer relationship for transfer pricing, it may have come at a cost. A common district reaction, at least at the outset, was that APA participants were “deceiving” the National Office, which has much less familiarity than the district with the taxpayer’s detailed history and operations.¹⁴⁴ This concern (as well as an appreciation of the learning curve savings in time and resources that the district can bring to the process) may have prompted the Service to make the district a more formal and active part of the National Office APA process in the 1996 updated procedure.¹⁴⁵

Another source of concern regarding the participant changes is the potential for manipulation of the process. Given that the district-taxpayer relationship may be mutually strained, but that the APA process can be initiated only by the taxpayer, strategic uses of the program may be possible, leaving the district averse to the APA program. Again, the 1996 changes to the program may reflect sensitivity to this concern and to the importance of having the districts as partners in a process in which they are both up-front and tail-end (in the audit of the APA years) participants. Furthermore, the introduction in late 1997 of a “program”

141. Eliot, *supra* note 68.

142. *Id.*; See also McLennan, *supra* note 28, at 437–38 (characterizing the APA staff of the Chief Counsel’s office as “generally more experienced and more knowledgeable than revenue agents in the field”); E. Miller Williams, Jr., *Basics of the U.S. Advance Pricing Agreement Program*, 13 TAX NOTES INT’L 723 (Aug. 26, 1996) (characterizing APA process as less confrontational than audit and noting that the APA process (unlike audit with its possible focus on the desired tax results) seeks to determine the correct methodology).

143. *Hitachi Explains How Bilateral APA Resolved Decade of Audits, Years of Outstanding Issues*, 7 TAX MGMT. TRANSFER PRICING REP. 59 (June 3, 1998).

144. Cf. John Turro, *Apple Computer Readies for APA Replay*, 5 TAX NOTES INT’L 278, 279 (Aug. 12, 1992) (noting view that field examiners “would be better able to verify the company’s [APA] submissions than the National Office personnel”); Kathleen Matthews, *Major U.S. Trading Partners Respond to U.S. Transfer Pricing Regulations*, 94 TAX NOTES INT’L 205–3 (Oct. 24, 1994) (taxpayer finding field role in APA process makes meeting “more like an examination than a negotiation”).

145. See Rev. Proc. 96-53, *supra* note 12.

that encourages field examiners to recommend appropriate taxpayers for the APA process could have a balancing effect.¹⁴⁶

In addition, the involuntary nature of the taxpayer-government relationship in traditional audit and litigation of transfer pricing contributes to the difficulty in dispute resolution. Although most audits are probably involuntary and negative from the taxpayer's perspective, this element of the relationship may be even more crucial in a substantive area such as transfer pricing which is already burdened with other baggage (lack of information, significant uncertainty, and high dollar amounts). A taxpayer resolving transfer pricing through the APA program may be inclined to approach it with a different attitude because it is a mutually beneficial interaction. Unlike the audit context, the taxpayer comes forward and initiates the process in exchange for certainty and the opportunity to influence the development of transfer pricing.

For example, in global trading, which posed some potentially unusual issues, the taxpayers that participated in the APA process presumably had an impact on the way in which such transactions were handled as reflected in Notice 94-40 and the subsequent global dealing regulations. The Service, having chosen to establish the APA process, similarly views it as a beneficial interaction for the reasons outlined earlier,¹⁴⁷ including the perceived administrative savings from reduced controversies,¹⁴⁸ the ability to gain more detailed information relevant to improved transfer pricing guidance, and the opportunity to interact with foreign governments in developing transfer pricing policies and fleshing them out through concrete applications. The result is a more mutually beneficial activity sought by both sides that requires the cooperation of both to work. Emphasis on the "voluntary" nature of interaction with the government in the APA process, as compared to audit, may seem inconsistent with some of the reasons taxpayers are attracted to the APA program. How can the APA be viewed as voluntary if taxpayers are drawn to it because of a difficult current audit or because they anticipate audit and double tax problems in the future and view the APA process simply as a more cost effective package than audit, appeals and litigation? Considered in this light, there is the unstated view that resolving transfer pricing is not really an elective act of the taxpayer, but

146. "IRS Launches Program to Identify Likely APA Candidates at Beginning of Audits," 6 TAX MGMT. TRANSFER PRICING REP. 331 (Oct. 1, 1997). See *infra* note 184.

147. Except in the case of some district offices that may view their participation in the process as having their hand forced by the taxpayer who has the choice.

148. See, e.g., NONPAYMENT OF TAX, *supra* note 7, at 21-22 (for cases closed in fiscal year 1993 and the first half of fiscal year 1994, the Service spent 1/3 of its total international examiner time and much more of its economists' time on cases with an I.R.C. § 482 issue).

rather something that must be accomplished in some forum. The arguments about voluntariness and inevitability, however, are not contradictory but rather target different concerns. The emphasis on voluntariness and its effects on relationships can be understood as a choice about the forum, when in many cases the use of some forum is inevitable.

c. Limited Authority

To the extent that transfer pricing issues are difficult and involve other countries, the district has somewhat limited opportunities for creativity and flexibility. The APA program, however, introduces participants (the National Office/APA team in the Chief Counsel's Office) with a broader scope of authority than the district or appeals levels.¹⁴⁹ This authority derives from a number of features, including the administrative structure of authority in the Service and the ability to draw upon treaties in reaching particular tax results.

As to structure, the National Office's mission is "to develop broad nationwide policies and programs for the administration of the internal revenue laws and related statutes, and to direct, guide, coordinate, and control the endeavors of the Internal Revenue Service."¹⁵⁰ The Chief Counsel for the IRS, who functions as part of the National Office, serves as the chief legal advisor for the Service.¹⁵¹ The duties performed by the Chief Counsel's Office include providing legal opinions, preparing rulings and technical advice memoranda, and assisting litigation, treaties, regulations, and recommendations for offers in compromise and closing agreements.¹⁵² Thus, the National Office, in part through the activities of the Chief Counsel, provides the centralized tax law guidance

149. See *infra* note 153. Cf. McLennan, *supra* note 28 (GM former chief tax officer characterizing IRS agents as more results oriented and revenue driven than the Chief Counsel's Office).

150. Internal Revenue Service Manual (IRM) 1112.21; see also JOINT COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF PROPOSALS RELATING TO THE RECOMMENDATIONS OF THE NATIONAL COMMISSION ON RESTRUCTURING THE INTERNAL REVENUE SERVICE ON EXECUTIVE BRANCH GOVERNANCE AND CONGRESSIONAL OVERSIGHT, JCX-44-97 (1997) [hereinafter JT. STAFF DESCRIPTION].

151. Traditionally, the Chief Counsel has served under the direct authority of the Department of Treasury. JT. STAFF DESCRIPTION, *supra* note 150. Under the IRS Restructuring and Reform Act of 1998, the Chief Counsel generally will now report directly to the Commissioner. However, joint reporting to both the Commissioner and the General Counsel for the Department of Treasury will be made with respect to (1) legal advice and interpretation of the tax law not solely relating to tax policy, and (2) tax litigation. In the case of legal advice or interpretation of tax law relating solely to tax policy, the Chief Counsel will report to the General Counsel. See I.R.C. § 7803(b).

152. JT. STAFF DESCRIPTION, *supra* note 150; I.R.C. § 7803.

for Service personnel.¹⁵³ For example, the National Office (attorneys in the Chief Counsel's Office) provide Field Service Advice Memoranda ("FSAs") in response to inquiries from these personnel. A major goal of the FSAs is to ensure "that field personnel apply the law correctly and uniformly."¹⁵⁴

The National Office, as the locus of international negotiating power in the Service, has been able to rely on treaty authority to achieve resolutions in APAs that arguably are not available under current law.¹⁵⁵ (This feature of the tax system may strike some readers as inappropriate. However, such a result should not be considered lawless; rather it reflects the legal and practical relationship between the Internal Revenue Code and tax treaties). In negotiating APAs on interbranch transactions, the APA program in the National Office recognized the "existence" of branches in a way that would have been constrained had only domestic law (and not treaty authority) been available.¹⁵⁶ For certain taxpayers, especially banks and financial services entities that regularly engage in business motivated interbranch transactions, the U.S. tax rules on branches can produce unpredictable and uneconomic tax results. The rules usually will not recognize interbranch transactions, that is, transactions between branches or offices of a single legal entity such as a corporation. The rationale is that a taxpayer cannot contract with itself.¹⁵⁷ In an effort to circumvent this domestic tax treatment, some taxpayers were thought to be using the APA process to obtain *de facto* recognition of these transactions. Without specifically acknowledging this claim, the Service announced in 1995 that it had completed its first cross border interbranch APA.¹⁵⁸ The Service explained that it had relied on its

153. SALTZMAN, *supra* note 54, at 1-6, 1-10.

154. *Tax Analysts v. IRS*, 117 F.3d 607, 609 (1997).

155. If the Service is deciding how to tax a given transaction it is supposed to follow the existing statutory and regulatory regime (i.e. the Code and regulations). For example, in issuing a letter ruling prior to a transaction, or taking a position in audit afterwards, the Service is expected to rely on the tax rules in place. However, if the transaction is cross border and involves more than one taxing authority, the picture changes. Thus, if after the transaction conflict emerges between the two countries' tax treatment, they will attempt to resolve it through the competent authority mechanism operating under the relevant tax treaty. In the process of reaching resolution, the U.S. competent authority may have the discretion/authority under the treaty to depart from the Code and thereby reach a result not strictly available under existing domestic law. (Note that a treaty cannot be used "against" the taxpayer to produce a result more adverse than that available under the Code.) In the APA process, the negotiation and debate between the United States and other countries occurs prior to the transaction, but because it takes place under the aegis of the tax treaty framework the same authority is available to the Service in determining tax treatment.

156. *See, e.g.,* Ring, *supra* note 88.

157. *See id.* at 668.

158. *See* First APA Covering Cross-Border Interbranch Bank Transactions Concluded, 1995 Daily Tax Rep. 45 G-1 (BNA 1995).

authority under the mutual agreement provision of the relevant treaty to provide a tax result not otherwise available under U.S. statutory law. The Service issued this APA as soon as it concluded that it had the authority under the treaty to recognize interbranch contracts, despite its inability to do so under purely domestic law.¹⁵⁹ This is a paradigm of how the National Office, which is the dominant governmental player in the APA process, can bring more flexibility to the table than the district or appeals offices in the audit/appeals process.

Related to the observations about the impact of the National Office's authority, is the impact of the foreign governments' presence in the APA process. The inability of the taxpayer and the district to bring the foreign taxing authority to the table in the audit/appeals process means that the U.S. audit of the taxpayer often takes place in the shadow of what is happening or may happen in the other country. Although competent authority is available to address potential issues of unresolved double taxation, as noted earlier, the time frame for this involvement is long and most importantly, it occurs *ex post*, typically as the last stage in resolution of a cross border issue.¹⁶⁰ Thus, the inclusion of the foreign governments in the APA process dramatically impacts the dynamics of the negotiation. As the percentage of requests involving bilateral or multilateral APAs approaches 75% of total requests, the availability of foreign governments can improve cooperation and certainty.¹⁶¹

B. Evaluation

The changes wrought by the APA program significantly respond to the two major administrative problems that bog down transfer pricing review by the Service (i.e., uncertainty and difficult dispute resolutions). In both areas the changes were fairly successful in improving administrability, with some reservations. The degree of success depended on the combined interaction of the changes. Although

159. *Id.* At the time this first APA was announced, the Service had ten interbranch APAs pending, suggesting the importance of this issue and the flexible APA treatment. *Id.* See generally "Practitioners Find Documentation Process for Interbranch Deals Difficult, Tedious," 3 FINANCIAL PRODUCTS REPORT 986 (Jan. 16, 1998) (noting that taxpayers, particularly bankers, turn to the APA process to cope with interbranch financial product transactions to have them recognized for tax purposes). The proposed global dealing regulations (issued in March 1998) provide some more generally accessible relief from this failure to recognize interbranch contracts. See generally Yaron Z. Reich et al., *Proposed Regs on Global Dealing Operations*, 78 TAX NOTES 1689 (1998).

160. See, e.g., *International Issue Resolution Through Competent Authority Process*, 64 TAX NOTES 657, 661 (1994) (noting the competent authority process has been criticized for its slow pace and that in 1990 the average process time was about three and a half years, although it has since been reduced).

161. See *Record High*, *supra* note 110, at G-1.

individually the changes would have been insufficient (as suggested earlier, "certainty" with the United States, though helpful, is of limited value for taxpayers facing other, active taxing jurisdictions), in combination they created a more administrable path for transfer pricing.

1. Hybrid Nature of APA Program

How the combination of these changes worked can be understood by seeing the APA program as a hybrid of administrative actions that traditionally were either *ex ante* functions (specifying rules applicable to taxpayers up-front) or *ex post* functions (formalizing tax treatment, providing certainty to individual taxpayers and negotiating with foreign governments). In contemplating the design of the APA program the Service did not limit consideration to the existing patterns of Service interactions with taxpayers. Changes included not just isolated modifications, but also expansive, interactive decisions that together substantially reshaped the Service's approach. For example, changes in timing that provided government interaction before the transaction were needed for improved certainty. The new structure also required the involvement of foreign countries and of officials with sufficient authority to craft more creative results. Thus, success hinged on a mechanism that, in a single procedure, reordered the taxpayer's relationship with both the Service and the foreign country.

Although transfer pricing issues frequently rise to the level of direct clashes between countries over pricing, the actual multilateral discussions typically occur only *ex post*. *Ex ante*, the countries operate individually to develop and implement their rules; taxpayers confront each country separately.¹⁶² It is only *ex post*, and more specifically after audit and domestic resolution, that the interaction of the two (or more) countries' tax systems on the transaction are fully evaluated. The APA process, as a hybrid, eliminates the separation and brings the multilateral discussion into the planning stage where the various advantages outlined above are enjoyed. This package of changes would not have been possible if the Service had been constrained to follow the existing patterns of *ex ante* and *ex post* involvement with taxpayers. However, this hybrid nature produces not only the core of the APA procedure's success in administrability, but also the seeds of its problems (both perceived and real), particularly for nonparticipants as explored below in Part IV.

162. Of course general international dialogue through organizations such as the OECD do produce serious discussions. *See, e.g.,* COMM. ON FISCAL AFFAIRS, ORG. FOR ECON. COOP. AND DEV., TRANSFER PRICING AND MULTINAT'L ENTER. (1979).

Translation of this picture of the APA program into the language and framework of administrative law can offer insights from that discipline. The traditional administrative law analysis begins with the division of administrative functions into rulemaking and adjudication.¹⁶³ Although it is widely acknowledged that the line between the two is not solid,¹⁶⁴ the division provides a rubric for assigning tasks, responsibilities, power, and limits to agency actions. Appropriate agency activity usually can be placed in one of the categories. A variety of factors distinguish rulemaking from adjudication. In all cases these factors are only general tendencies, not absolute descriptions.¹⁶⁵ One of course is the "timing" of the administrative action's effect—does it impact past or future events (a version of the *ex ante/ex post* observation).¹⁶⁶ Others include that rulemaking: (1) focuses on the general rather than the specific,¹⁶⁷ (2) entails the elaboration of standards,¹⁶⁸ (3) is generally publicly stated and accessible,¹⁶⁹ (4) allows broad participation in its creation,¹⁷⁰ (5) is usually more binding on the agency,¹⁷¹ and (6) is more likely to come from higher authority (at least compared to initial adjudicatory action).¹⁷²

Measured against this basic framework, the APA program is problematic because it defies straightforward categorization. The very features that contributed to the APA program's hybrid format create this unorthodox picture. The primary concern with this uneasy classification is that the checks and constraints of the standard rulemaking/

163. See, e.g., Ralph F. Fuchs, *Procedure in Administrative Rule-Making*, 52 HARV. L. REV. 259, 259 (1938) (identifying rulemaking and administrative adjudication as the "primary categories in the study of administrative law").

164. See, e.g., David L. Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Administrative Policy*, 78 HARV. L. REV. 921, 924 n.7 (1965) (noting critiques of the "rulemaking-adjudication dichotomy" on the grounds that it operates on the assumption that "clear lines can be drawn").

165. See, e.g., *id.* at 930–42 (outlining certain characteristics of rulemaking, but observing the ways in which adjudicatory proceedings can reflect the same qualities).

166. See, e.g., 5 U.S.C. § 551(4) (1994) (the Administrative Procedures Act defines a rule as "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy . . ."). See generally Frederick Schauer, *A Brief Note on the Logic of Rules with Special Reference to Bowen v. Georgetown University Hospital*, 42 ADMIN. L. REV. 447 (1990) (examining the meaning and role of rules); Fuchs, *supra* note 163, at 260.

167. See Schauer, *supra* note 166, at 450–52; see also Fuchs, *supra* note 163, at 263; see also Freeman, *supra* note 1, at 14.

168. See, e.g., Shapiro, *supra* note 164, at 926–27.

169. Cf. *id.* at 940–41.

170. See, e.g., *id.* at 930–31.

171. See, e.g., *id.* at 926.

172. See generally *supra* text accompanying note 153 for discussion of the National Office role.

adjudication dichotomy are absent, leaving agency discretion unrestricted. The importance and consequences of controlling agency discretion through the rulemaking/adjudication distinction are pursued in greater detail in Part IV. For the present, it is useful to note that the APA program's case by case approach, the absence of extensive explication of standards, the degree of nondisclosure, the limited range of participants (i.e. only one taxpayer per APA), and the implicit expectation of flexibility for the Service to change its position with later taxpayers, point towards an adjudicatory classification. However, the APA's guarantee up-front of specific tax treatments for future transactions and the high level of Service personnel involved demonstrate core rulemaking qualities. Changing these features of the APA program to align more closely with traditional rulemaking or adjudication would likely impair its function and "success". The question, therefore, is how much flexibility should be permitted on the rulemaking/adjudication pattern? Parts IV and V explore the effects of granting agencies some opportunity to work outside of the standard framework.

The *ex ante* nature of the APA program features prominently in Part IV's critique from a tax system implementation perspective and in Part V's analysis from an administrative law perspective. Nonetheless, it is important to be clear that the APA program's success in ameliorating the structural and procedural problems of transfer pricing was not due simply to the program's *ex ante* nature. As indicated by the changes described above, both the timing and the type of government interaction were critical. As to timing, the *ex ante* aspect eliminates taxpayer concerns about penalties and documentation, provides the government with more detail on taxpayer business, and facilitates coordination with other governments because immediate dollars are not at stake. An *ex post* format, even an informal one such as arbitration, might not achieve the same benefits as the APA program in terms of attracting foreign countries. While it is not impossible to imagine other countries agreeing to participate in such transfer pricing arbitration, it could nonetheless be difficult to implement bilateral arbitration. Part of what the countries are achieving in the APA process is some level of agreement on transfer pricing rules. It might, therefore, be hard to provide arbitrators with an agreed set of rules without the parties themselves actually conducting negotiations.

As to the type of interaction, the informality of the APA negotiation process contributes to the program's success. That the parties have the flexibility to examine the transactions and develop bilaterally acceptable treatment is both a draw and a key to achieving resolution. A rigid process, even if *ex ante*, would be unlikely to deliver comparable

success, because it would limit the parties' (including the U.S.' and foreign governments') opportunity to modify, refine, and develop their transfer pricing practices in an interactive setting.

2. Parallels to Other Regulatory Reform

Comparison here of the APA program to recent developments in the environmental area highlights common problems that both regimes sought to solve through procedural innovations. Like transfer pricing, environmental regulation (which classically operated from a command and control structure)¹⁷³ has suffered from a number of limitations. The central planning approach fails to gather enough information to help design responses sufficiently sensitive to a range of environmental and business situations.¹⁷⁴ Data gathering is also impeded by distrust of government and the lack of incentives for industry to share information or openly participate with the government.¹⁷⁵ The complexities of some environmental issues such as the cleanup programs¹⁷⁶ have led to high transaction costs in determining liabilities and remedies. Moreover, the scale of liability in these cases significantly raises the stakes for the parties.¹⁷⁷ Finally, the international implications of environmental regulatory action in the United States have increased with global integration.¹⁷⁸ As difficult as a rigid command and control approach may

173. See, e.g., Richard B. Stewart, *United States Environmental Regulation: A Failing Paradigm*, 15 J.L. & Com. 585, 585-87 (1996) [hereinafter *Paradigm*] (describing the centralized, rigid, and uniform approach to regulation); Richard B. Stewart, *Models for Environmental Regulation: Central Planning Versus Market-Based Approaches*, 19 B.C. ENVTL. AFF. L. REV. 547, 551 (1992) [hereinafter *Models*] (the command and control approach has "produced uniform, inflexible standards that result in high compliance costs, restrict innovation, discourage efficient use of resources, and require detailed central planning of economic activity."); Sunstein, *supra* note 1, at 627 ("[a] large source of regulatory failure in the United States is the use of rigid, highly bureaucratized 'command-and-control' regulation.").

174. See Stewart, *Paradigm* *supra* note 173, at 587. See also Sunstein, *supra* note 1, at 627 (a major factor in regulatory failure in fields such as environment protection is the "rigid, highly bureaucratic 'command-and-control' regulation . . . [and] programs [that] dictate national control strategies for hundreds, thousands, or even millions of companies and individuals in an exceptionally diverse nation").

175. See, e.g., Freeman, *supra* note 1, at 70 (to the extent regulatory negotiations are viewed as a zero-sum exercise, granting the government more open access to business and operating information is considered "crazy"). A separate incentive question frequently surfaces in environmental regulation discussion—the issue of whether particular modes of regulation encourage or discourage industry from developing better technologies such as pollution controls. See, e.g., Stewart, *Paradigm*, *supra* note 173, at 589.

176. See, e.g., *id.* at 590 (discussing the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA")).

177. See *id.*

178. See *id.* at 595.

be on the domestic front, its failure internationally is magnified. Many of these enumerated environmental regulatory problems parallel those in transfer pricing (e.g. role of facts, reliance on generalized regulations for diverse circumstances, high stakes, high transaction costs, absence of incentives to disclose information to the government, importance of international coordination with growing cross border volume).

Significant differences do remain. Environmental regulation, like other health and safety fields, represents an intervention by the government into market practices. As a result, justifications for such intervention, and assessment of its success often rely in part on market based terminology and comparisons.¹⁷⁹ For example, critiques of environmental regulation often focus on inefficiencies created where a regulation designed to mitigate some market failure ultimately costs more than the initial harm. Reform efforts here challenge “command and control” regulation and tout the benefits of a “presumption in favor of flexible, market-oriented, incentive-based regulatory strategies.”¹⁸⁰ Environmental regulation also differs from transfer pricing in that it has a wider immediate audience. More parties perceive a direct impact from environmental regulation. Not only is the regulated entity deeply concerned, but the “community” facing the environmental risk may be as well. In contrast, although the taxpayer views its transfer pricing problem as material, the broader public lacks a clearly defined role.

Despite these differences in market orientation and scope of participants, the significant operational similarities in the two fields have led to the development of related innovations such as the focus on redefining the parties’ interactions to create a more successful process. On the negative side, as considered further in Parts IV and V, the turn toward procedural improvements produced parallel difficulty in measuring quality and value beyond the assessment of functional and operational success.¹⁸¹

179. See, e.g., Croley, *supra* note 1, at 4 (agencies whose main purpose is redistributive and lack a market counterpart, e.g., Social Security Administration or the Internal Revenue Service, differ in part from those whose work is to modify behavior that would otherwise be produced by the market); Sunstein, *supra* note 1, at 618–19 (describing value and importance of private markets but outlining market failures that justify social regulation).

180. Sunstein, *supra* note 1, at 633. See also Stewart, *Models*, *supra* note 173, at 547 (“As the high cost and limited effectiveness of [command-and-control] tools has become more evident, the United States has begun shifting to the use of market-based incentives in its environmental policies.”).

181. See, e.g., Cary Coglianese, *Assessing Consensus: The Promise and Performance of Negotiated Rulemaking*, 46 DUKE L. J. 1255 (1997).

3. Further Questions on the APA Program's Effectiveness

However, understanding the critical ways in which the APA program confronted the sticking points of transfer pricing and comparing them to choices made in other fields is only part of the inquiry into effectiveness. Several other significant questions remain. The first concerns the degree of impact of the program—its actual significance. The portion of transfer pricing business funneled through the program is small. Although the program draws large multinationals, the total number participating is only a fraction. Moreover, even though the agreements may cover a high dollar segment of the participating multinational's business, it typically does not cover all of that taxpayer's transfer pricing. Whether this level of volume should influence the perception of the program's success depends on its goals, short and long term. Allowing the program to serve as a pressure valve for taxpayers facing serious problems (e.g., audit relations, double taxation or predictability in light of penalties) may be acceptable if the program can ultimately improve transfer pricing generally. Clearly, that has been an explicit goal of the Service—to provide better transfer pricing guidance in formats available to all taxpayers. As discussed in Part IV, there has been limited success to date on that front.

Alternatively, even if the program encompasses an increasing number of taxpayers and transfer pricing business, through expansion of Service personnel and growing taxpayer interest, does it justify the government's expenditure of resources in running the program? Such a question, which calls for comparisons and projections of the expenditure of resources in audit and in the APA program, is the next logical empirical inquiry if it is established that the program is useful and working on other dimensions.

The second area of concern regards the procedural fairness of the process. Resource allocation aside, does the creation of this alternative path pose problems of fair and equitable treatment of taxpayers regardless of the method of dispute resolution selected? Part IV examines this question in greater detail and offers suggestions on what features are critical to ensure a level of procedural equity. However, the focus in Parts III and IV on different aspects of the procedural impact of the program should not completely overshadow the question of the substantive nature and quality of APA outcomes.

Certainly the design and focus of the APA program was a direct response to a number of procedural and structural problems with the baseline system for handling transfer pricing. Thus, the initial measurements of success look to whether the changes effectively respond to those procedural and structural problems, and whether they

generate any new ones. Nonetheless, procedural changes can have an equally powerful impact on the substantive soundness of outcomes. As noted, one hope for the program has been that a deeper understanding of taxpayer businesses and transactions could help the Service design better transfer pricing treatments. But evaluation of the actual substantive APA results turns on data not publicly available at present, although the prospect of annual APA program reports improves the chances for future study. Unfortunately, to determine whether the APA process is having a negative impact on substantive outcomes, as compared to results obtained through non APA channels, requires audit data that is even less likely to be publicly available.

A third set of concerns involves the question of abuse and strategic behavior in the APA process—in particular the bargaining strength of the parties and the taxpayers' powers of self selection. As to bargaining power, if the Service has been unsuccessful in litigating transfer pricing cases, why would a taxpayer agree to participate in the program without being guaranteed a good deal? That is, what kind of bargaining power can the Service have in the program?

Despite its historical problems in litigation, the Service's position in the APA program is considerably stronger for several reasons. First, the new documentation requirements and penalties for improper transfer pricing¹⁸² raise the stakes for taxpayers—because the price of losing, even if unlikely, is much higher. Second, the intensified attention by foreign governments' to transfer pricing increases the possibility of double taxation. Third, for taxpayers in more uncharted territory, such as global dealing and for which existing rules work poorly from an economic perspective,¹⁸³ the prospect of reaching an initial agreement with the Service may be more appealing. Finally, the costs of audit and litigation, even if successful, may be significant and worth eliminating.

In terms of strategic possibilities for taxpayers, they certainly exist. By virtue of being a voluntary program for taxpayers, presumably participants and nonparticipants self select to be in the most individually favorable category. Thus, for example, a taxpayer who is willing to take an aggressive transfer pricing position and who believes audit can be avoided, will not enter the APA program. Conversely, taxpayers displeased with audit prospects (whether because of relations with the district, challenges from other countries, or details of the domestic law) will opt to enter the program. Such is the nature of any voluntary program with the government. Whether it ultimately poses a problem

182. See I.R.C. §§ 6038A, 6662.

183. See Ring, *supra* note 88.

depends on how much the government benefits from the participating taxpayers, and the government's ability to maintain some serious audit pressure on nonparticipants.

In addition to the prospect of taxpayer self-selection for the program, is the possibility of taxpayers manipulating unduly favorable agreements. For example, if a taxpayer who has negotiated one or more APAs for its various businesses finds one of the APAs to be very favorable, it might seek to divert a large portion of business through the entity with the good APA. The degree to which such a strategy could be pursued is limited. For an APA to remain valid, various assumptions about the business, economic environment and transactions must continue to be true. Thus, while the business volume in the favored entity could be expanded, it would not be possible to channel other activities through that entity and receive the APA coverage. Moreover, the term of an APA is restricted, typically to three years. The upside is that any Service mistakes have a finite duration. The negative is that renegotiations are required to extend the coverage of an expiring agreement, although the scope and depth of such discussion can vary significantly.

The conclusion at this stage is that the APA program as a procedural response to a problem of tax administration has been relatively effective in its direct application as measured by taxpayer and government participation in a process that achieves resolution and furthers international dialogue. Assessment of particular substantive effects requires further information. However, the procedural and administrative analysis does not end with the investigation of the APA program's internal dynamics. Instead, the consequences of this procedural development for nonparticipants, and for the quality of the tax system generally, must also be scrutinized.

IV. EFFECT OF THE APA PROGRAM ON NONPARTICIPANTS: THE SILENT PIECE OF THE PROCEDURAL HYBRID

The pervasive sense of frustration and failure with respect to transfer pricing motivated the creation of the APA program. The three major changes described in Part III were successful in improving the function and administrability of the system for direct participants. As a result, the tax system has an alternative dispute resolution path for transfer pricing that seems to work for some taxpayers facing difficulty in the traditional audit, appeal, litigation route.

The question considered here is the impact of the program on nonparticipants and the secondary effects of this alternative procedure on the tax system. For taxpayers who have transfer pricing issues but are not involved in the APA process two major areas of concern emerge: access/participation and results. In the course of examining these concerns, a third interrelated issue, disclosure, emerges as central in both potential problems and solutions for nonparticipants. Thus, this Part first considers the nature of access to and participation in the APA program. Second, it explores the question of comparability of results between APA and non-APA paths. Finally, drawing upon some of the complications identified for participation and results, this Part examines the contours of the APA program's disclosure policy in an effort to reconcile the program's treatment of participants and nonparticipants.

Ultimately, the APA program is part of a broader tax system that must operate and be analyzed as a whole. No one piece functions independently. Therefore a new procedure's impact on those not opting for it can be just as significant as its direct effects, in terms of evaluating the success or merits of the procedure. The criteria for evaluating the "success" or "usefulness" of the APA program become more complex when the ramifications of the program for the tax system and nonparticipants are taken into account. In that area, more of the tradeoffs of the program emerge—and measuring them turns on several criteria including horizontal equity; "correctness" of rulemaking; fostering of international cooperation; and transparency of process. None of these goals or criteria is paramount or exclusive. Different criteria have more or less salience for the various issues raised here in Part IV.

A. Taxpayer Access and Participation

To the extent the APA program represents a partial remedy to problems faced by taxpayers with transfer pricing issues, a significant question is who can participate (i.e., are there limits on access and participation)? As an initial matter, however, the general topic of "taxpayer access" to the APA program cannot be taken literally. In theory, any taxpayer with a transfer pricing problem can approach the APA office with a request for either a unilateral or bilateral/multilateral APA. In fact, the entire program has a strong element of taxpayer control and electivity because only the taxpayer can initiate the procedure. Hence the APA program serves as the taxpayer's trump card in

interactions at the district level because the Service cannot force the taxpayer into the process.¹⁸⁴

The first problem of participation and access emerges from the profile of who seeks an APA. "Profile" reflects an assessment of motive, as well as a description of key taxpayer characteristics such as size, country of origin and industry. Approximately 187 APA applications are pending, and almost 75% are for bilateral or multilateral APAs.¹⁸⁵ An initial observation from the profile statistics is that larger multinationals are seeking APAs, even though both large and small businesses face serious transfer pricing problems.¹⁸⁶ That is, taxpayer size relates to who gets an APA. Although the existence of APAs is presumably advantageous to taxpayers generally (because they have the option to decide if, when, and for what issues to pursue one), in practice smaller taxpayers have lacked that option because of cost. Regardless of company size, the cost of pursuing an APA is not trivial.¹⁸⁷ As outlined earlier, however, APAs can be less expensive than the alternative of audit, appeal and litigation. In assessing this cost savings, however, a taxpayer must consider the probability of audit as well as the probability that the transfer pricing issue will be identified. Larger companies are more likely to view audit as inevitable, and thus more likely to find the savings attractive.¹⁸⁸ In addition, to the extent the total cost of an APA is

184. One counterpoint is the early referral program initiated Oct. 1, 1997 through which the Service's district offices seek to identify taxpayers who have a transfer pricing issue in audit that may be appropriate for an APA. See Rev. Proc. 96-9, 1996-1 C.B. 575. The decision whether to pursue an APA remains with the taxpayer, and few have chosen that path. See Albertina M. Fernández, *Use of Secret Comparables Goes Against Nature of APAs, Official Says*, 79 TAX NOTES 1233 (June 8, 1998) (quoting APA Program Director Richard Barrett on the very limited taxpayer response to the early referral program); *IRS Concludes First Cost Sharing APA with Low Buy-In as Prime Issue, Barrett Says*, 8 TAX MGMT TRANSFER PRICING REP. 571 (1999) (only two taxpayers thus far have sought an APA via the early referral program). That said, the picture is more complex because some taxpayers may find themselves "compelled" to pursue an APA, while others may find they face practical barriers to presenting an APA request. For example, a history of troubled transfer pricing audits or transactions in foreign countries that actively pursue transfer pricing could lead a taxpayer to feel compelled to pursue an APA. See *supra* note 105.

185. See *Record High*, *supra* note 110, at G-1.

186. See e.g., I.R.S. Notice 98-10, 1998-6 I.R.B. 9 (noting that small business taxpayers were not participating in the APA program to the same extent as large taxpayers, at least in part due to cost).

187. Even though the government fee for filing an APA application is calculated on a progressive fee schedule, the other costs including lawyer and accountant fees, expert reports, as well as internal resources devoted to the process are not so easily scaled.

188. Large corporations (those with more than \$10 million in gross assets) are divided into two groups for purposes of audit. Corporations with assets exceeding \$250 million are audited under the Coordinated Examination Program; the others under the general audit program. See SALTZMAN, *supra* note 54, at 58-15 to 58-19. The "inevitability" of audit, however, is not a guarantee that a particular issue will be spotted. Also, in some cases, the fact

not directly related to taxpayer or issue size, larger taxpayers can absorb the cost more easily.¹⁸⁹ This constitutes a participation concern because there appears to be no policy intent to limit access to larger taxpayers, thereby disadvantaging smaller ones where the two are competitors.¹⁹⁰ That is, differential participation poses concerns for horizontal equity to the extent that there seems no relevant distinction between larger and smaller taxpayers. Although it might be argued that smaller taxpayers would be less likely than larger ones to have the resources to swamp the Service in a transfer pricing audit and would be more willing to pursue an APA, the costs of the APA process can be significant enough to discourage their participation.

The initial structure of the APA program offered no remedy for this access and participation concern. The 1996 revised procedure introduced a sliding scale user fee, but that only mitigated the direct government fee for the procedure and not the more costly advisor fees and internal resource allocations.¹⁹¹ The Service, however, expressed concern for small taxpayer participation,¹⁹² and recently initiated a more streamlined track for certain small businesses.¹⁹³ Although this formal response to the participation problem is important, its limited scope must be noted. At present, the new track is available only for certain types of transfer pricing issues (the ones perhaps more likely to need in depth

that the APA costs are certain and must be incurred today makes it more difficult for a corporation's tax department to convince management to allocate the funds needed to pursue the APA—even when a best estimate cost comparison (including time discount) favors the APA process.

189. See e.g., Timothy W. Cox, *Australian Tax Office Releases Draft Ruling on Advance Pricing Agreements*, 9 TAX NOTES INT'L 1279 (Oct. 24, 1994) (noting that although the APA process provides certainty and eliminates double tax, it may not be cost effective for small businesses).

190. Arguably, this concern about small taxpayers is neither new nor unique; taxpayers with more resources often may have more options and more success in the tax system. However, it may be more important where the resource question directly impacts the taxpayer's opportunity to participate in a procedure which itself is the response to a problematic area of taxation.

191. See Rev. Proc. 96-53, *supra* note 12.

192. The Service has indicated for some time that it was aware of the burdens of the process on smaller taxpayers, and was contemplating ways in which to address it. See, e.g., Kathleen Matthews, *U.S. Branch IFA Meeting Highlights Cross-Border Corporate Reshufflings, Tax Treaties, APAs*, 8 TAX NOTES INT'L 776 (March 21, 1994) (then-APA director Robert Ackerman noting Service's interest in developing "truncated" APA guidelines for small taxpayers, those with \$100 million or less in sales); I.R.S. Notice 98-10, *supra* note 186 (inviting comment regarding a special APA process for small taxpayers). See also Temp. Treas. Reg. § 1.482-1T (1994) (the 1993 temporary regulations contained a safe harbor for small taxpayers which did not appear in the final regulations because of problems with its application).

193. See I.R.S. Notice 98-10, *supra* note 186.

evaluation—intangibles).¹⁹⁴ The Service's reluctance to expand the track is understandable in a large dollar subject like transfer pricing; perhaps the Service's indication that flexibility may be considered on a case by case basis reflects a compromise for developing a broader small taxpayer track.¹⁹⁵

The second access problem concerns whether differential participation in the APA process creates advantages for certain members of an industry.¹⁹⁶ If, within a given industry, some taxpayers seek APAs and other do not (and we might even assume that it is disproportionately the larger taxpayers which are seeking them), will the former taxpayers derive some competitive advantage over their non-APA seeking counterparts? For example, if the conclusions reached in APA negotiations with taxpayer A are not disclosed or are disclosed in a fairly limited form, then taxpayer B who does not seek an APA may receive different treatment than taxpayer A through the process of audit, appeal and litigation. That is, taxpayer B may not get the same rule.¹⁹⁷ Or, taxpayer B may find itself receiving the treatment granted taxpayer A without the opportunity to fully debate the appropriateness of its application, as taxpayer A did in the APA negotiations. The differences could have an important competitive impact if the transfer pricing issues involve large sums, seriously affect business structure, or carry interest and penalties. If taxpayer B could have sought an APA but simply chose not to, the subsequent discrepancies might not imply unfairness. But, if we believe that taxpayer B may have valid reasons for not pursuing an APA (e.g., cost, limited internal resources,¹⁹⁸ operations in a nontreaty country¹⁹⁹), then we may be particularly concerned about different outcomes.

194. See *id.* ("Transactions involving non-routine intangibles . . . would not ordinarily be amenable to such special procedures . . .").

195. See, e.g., *id.* at para. 7.

196. See, Stratton, *supra* note 58, at 139–40 (former Treasury International Tax Counsel Stephen Shay voicing concern over the absence of disclosure with APAs because for taxpayers competing in the same industry, the APA program "should not be a point to provide a competitive advantage over another company.").

197. As discussed in greater detail in the following section, results can vary for different reasons, and the reasons why they vary are important. See *infra* Part IV.B.1. Inappropriate variation will be most harmful within the same industry because of the competitive impact of taxes.

198. Pursuing an APA requires resources from the corporation itself in terms of gathering and organizing information, and negotiating. If the company faces other demands on its time and resources, an APA may not be realistic.

199. See Rev. Proc. 96-53, *supra* note 12, at § 7.01 ("bilateral or multilateral APAs generally are preferable . . . when competent authority procedures are available with respect to the foreign country or countries involved"). In the absence of a treaty and the corresponding

How do we evaluate this aspect of participation? Unlike the above discussion which focused on the affirmative opportunity to participate and the elimination of unjustified²⁰⁰ barriers to participation, this view of “participation” includes more than a direct role in the procedure. It includes access to the developments of the administrative process—the new rules, approaches and interpretations emerging from the APA program. One way of stating the problem envisioned here is that because of the hybrid nature of the APA program, a taxpayer that does not use the procedure to resolve a transfer pricing issue runs not only the risk of having a different “process” to resolve the issue but also of having a different rule applied. This fear, which arguably could exist across the board because taxpayers’ ultimate tax treatments are rarely made public, is fueled by the possibility for creating “private law” through the APA program.

As outlined above in Part III, an administrative regime like the tax system has both rulemaking and adjudication functions, although the degree of difference between the two is debated.²⁰¹ While acknowledging the fluidity between the two categories, attention should be directed to one of the traditional differences, timing.²⁰² The rulemaking function is an *ex ante* interaction in that it refers to identifying rules to which taxpayers will be held in their future transactions. In an open legal system, this kind of interaction or function should be uniform, consistent and visible; taxpayers should face the same rules up-front, before engaging in their transactions. Even if results vary, which they will for a variety of reasons,²⁰³ a taxpayer’s risk regarding potential tax treatment should be the same, so that the government is not inappropriately favoring one taxpayer over another. In

competent authority mechanism, the APA program lacks an avenue of interaction with another country to produce an APA.

200. A justified barrier would, for example, be one that requires taxpayers to explain their business and identify their competitors. A taxpayer not wanting to share any information in the procedure would not have a valid claim that its participation was unfairly limited.

201. See *supra* text accompanying notes 163–72. See, e.g., Fuchs, *supra* note 163, at 260–65 (discussing the difficulty in drawing distinctions between rulemaking/legislation and adjudication).

202. See *supra* text accompanying note 166. See, e.g., Fuchs, *supra* note 163, at 260–61 (noting partial reliance on the distinction that rulemaking concerns the future where as adjudication affects past or present events and relies on past facts).

203. Although both taxpayers entered into their transactions “knowing the rule to be applied,” the non-APA participant’s final treatment might differ from the APA participant’s because of several factors endemic to the *ex post* dispute resolution process (including taxpayer/district dynamic; large dollar gaps to negotiate; litigation risk; and view of foreign country), which are handled differently in the APA process. The importance of why results could be substantially different is considered in detail, *infra* Part IV.B.

terms of “similar”²⁰⁴ taxpayers, there is no reason that this standard cannot be met. Moreover, there is a value to fair process independent of actual results. The fact that rules can be developed through traditional adjudicatory proceedings, or that particular problems or cases can be resolved by a new rule, does not undermine the importance of the *ex ante/ex post* distinction in this context. The distinction and focus are not on rulemaking *v.* case resolution *per se*, but on the degree of risk or certainty possessed by the taxpayer at the time of the transaction, and the nature of the government interaction.²⁰⁵

The other basic function, adjudication, is an *ex post* interaction typically occurring after the taxpayer has engaged in the transaction under consideration (e.g., in audit). The important aspect of this function here is to produce results. The results themselves need not be the same because the “application” process (unlike *ex ante*) usually does not involve “comparable” cases—questions of litigation risk, proof and specific facts come into play. Of course, “new” rules or interpretations may emerge from the process. That, however, should pose no problem given the uniform *ex ante* risk faced by all taxpayers. Moreover, a pricing conclusion reached after the fact, perhaps at the appeals level where litigation risk and offsetting issues are relevant, would be of somewhat lesser planning value for other taxpayers.²⁰⁶

Although many actions reasonably may be classified as *ex ante* or *ex post*, the APA procedure is a hybrid that fits neither.²⁰⁷ Relative to the actual occurrence of covered future transactions, the procedure seems *ex ante* and calls for clear, established rules applicable to all. The procedure is also *ex post* in that it specifies final treatment (assuming taxpayer compliance with the agreement’s terms) and thus is more context specific. The hybrid nature of the APA program means that concerns about the impact on nonparticipants are especially poignant. To the

204. The analysis here assumes that one can identify sufficiently similar taxpayers for whom the tax system would seek to provide similar rules.

205. An initial criticism of these stated benefits of *ex ante* rule consistency questions what the real value is if taxpayers (and administrators) can both realistically predict that taxpayers with more resources can obtain (through the progress of audit, appeal and litigation) results substantially different from those that taxpayers with fewer resources can obtain. This challenge to the significance of *ex ante* rule consistency stands independent of the existence of the APA program. The response turns on the role of risk. While additional resources might improve a taxpayer’s chance of a successful outcome in a dispute with the Service, it is by no means guaranteed (and most certainly is not the tax system’s goal). Even that taxpayer bears the risk of undesired tax treatment.

206. This point is part of a larger and much more complicated consideration of the role of disclosure in the APA program and the tax system more generally. These issues are explored in greater detail in section B below.

207. See *supra* text accompanying notes 165–72.

extent a taxpayer engaging in the APA process obtains certainty about the rules to be applied to its transfer pricing, and to the extent such rules may differ from those clearly available to non APA participants, valid cause for concern exists. The APA participants would be obtaining a different rule, but with certainty and in advance of committing to the actual transactions—essentially a form of private law.

Where does this observation lead? It points to the questions addressed in the following two sections: results and disclosure. A taxpayer is ultimately concerned about its final tax treatment, the actual results it obtains. Depending on the comparability of transfer pricing results for APA participants and nonparticipants, we may be more comfortable about the degree of access to “new” rules. More generally, adequate disclosure of APA terms would help eliminate the veil that leaves nonparticipants (including taxpayers, Congress, and academics) uninformed about the new developments in the APA process.

B. Results and Comparability in APA Process

Both as a tool for evaluating participation and as an independent concern, comparability in APA and non-APA results is critical.²⁰⁸ Simply stated, the expectation here is that APA results should be comparable (i.e., a taxpayer should not be treated better or receive more favorable tax treatment simply because it used the APA process—the “private law” concern). However, an assessment of the comparability of results depends on understanding why results differ, and deciding whether the reasons they differ are appropriate. The question of results turns out to be complicated and reflects more than a debate over literal results. As suggested below, the use of the term “results” can be misleading as different observers may have different points in mind.

Before undertaking the inquiry two caveats must be noted. First, any analysis here is impaired by the absence of full information and the lack of data on a wide range of taxpayers and disputes. Moreover, even if APAs were substantially disclosed we would still need detailed information about other taxpayers’ treatment in audit and appeals to complete the study. Such information, however, is unlikely to be made publicly available in the near future. Second, the focus on results should not be taken to mean that there is a single correct tax treatment or tax due. Rather, it reflects the view that if certain premises are made in the

208. See, e.g., Stratton, *supra* note 58, at 139–40 (former Treasury International Tax Counsel Stephen Shay expressing concern that different taxpayers may be receiving different treatment through the APA process).

substantive tax law, then certain outcomes are sensible and plausible, and others are not.

1. Appropriate Reasons for Varying Results

Most comparisons of APA and non-APA results should reveal differences, but due to appropriate factors. This section identifies a number of significant but valid reasons for difference. The question then remains, what potential concerns linger?

The first reason results can appropriately differ is that the comparison is one of results received at different stages which have different roles and constraints. Thus, a comparison of APA results and audit (i.e., exam level) results must recognize exam's focus on identifying adjustments. Litigation risk may not be factored in at this stage. However, the expectation that appeals will be assessing litigation risk may push audit to produce a higher assessment to be negotiated and compromised later.²⁰⁹ The interaction between taxpayer and Service at this level, while not uniform, is structurally more adversarial than others. Additionally, an audit's duty is to find adjustments, it needs to justify time spent reviewing a taxpayer, and it is rewarded for passing on big dollar adjustments to appeals, which means differences should be expected.²¹⁰ Thus, APA results are not likely to equal those provided by audit.

Even the appeals stage is not the right point of comparison for an APA. Although appeals does consider litigation risk, and is the stage at which the taxpayer and Service explicitly negotiate and compromise, the results obtained at this level do not incorporate the views and positions of the other country or countries involved. That is the province of the competent authority proceeding. In addition, if an audit position is particularly extreme, then even subsequent appeals and competent authority negotiations may fail to bring the results back to the "more appropriate" point because of the practical constraints on appeals in

209. For example, for fiscal year 1993, \$900 million in proposed large I.R.C. § 482 issues were settled at a sustention rate of 27%. *See* NONPAYMENT OF TAX, *supra* note 7, at 24. The primary reason cited by the Service for reaching these settlements was hazards of litigation relating to facts or evidence open to judgment (accounting for 63% of the reduction to proposed I.R.C. § 482 adjustments). The next most important reason for settlement was "hazards of litigation relating to uncertainty about how the courts will apply the law." *Id.* at 25.

210. *See, e.g., id.* at 181 ("The U.S. General Accounting Office recently reported that taxpayers were able to settle transfer pricing cases at the Appeals level for an average of 24 cents on the dollar." (citing GAO Testimony Before Senate Governmental Affairs Committee: Updated Information on Transfer Pricing, Delivered March 25, 1993, Transfer Pricing 821 (Mar. 31, 1993))).

terms of conceding large adjustments. Appeals could also move in a slightly different direction than the APA because of explicit or de facto offsetting compromises on other issues simultaneously on the table. The opportunity for this kind of modification at the APA level is less likely because of the more limited jurisdiction of the APA program.²¹¹

Given the increasingly large fraction of cases which are bilateral or multilateral, the APA procedure is usually the first and final step in the process.²¹² The APA process can be seen as compressing a series of otherwise separate functions in the Service and producing the final result in a more unified manner and in a presumably shorter time period.²¹³ Thus, for taxpayers pursuing the traditional path, the proper point of comparison with an APA is the result ultimately emerging from the competent authority proceedings.²¹⁴ For both sets of taxpayers that is the final point for a given transfer pricing issue domestically and internationally. But even then, the sum of the individualized steps of audit, appeals, and competent authority, does not necessarily equal the condensed version—the APA.

A second basic reason results validly may differ is because of the underlying transfer pricing rules used in audit as opposed to the APA program. In contrast to most current audits and appeals, APAs are being conducted against the backdrop of the new transfer pricing regulations, whereas audit cycles under these new rules are only just beginning. Thus, differences would be expected. This point, however, should not be overstated. The actual implementation of the old rules through the audit process, appeals and competent authority, already incorporated more of the new regulations than would be supposed by a strict reading of the rules.²¹⁵ For example, the comparable profits and profit split methods, which were not explicitly authorized under the old regulations, but are “specified methods” under the new regulations, were nonetheless a factor in many transfer pricing discussions.

211. See Rev. Proc. 96-53, *supra* note 12.

212. This assumes that the taxpayer complies with the terms of the agreement and thus the agreement remains valid.

213. To the extent that taxpayers are able to package seven, eight, or nine years of issues together in a single process, resources should be saved because of the transfer pricing issues forgone. It should also ensure greater consistency in treatment across the years. It is, however, also possible to have audit cover an issue over several audit years. See, e.g., I.R.S. Manual Ch. 35 § 3(19)(6) (certain closing agreements may be used to provide “that resolution of an issue under consideration during an audit cycle can be applied to resolve the same issue in prior or subsequent tax years that have ended before the date of the agreement.”).

214. U.S. income tax treaties contain a “Competent Authority Procedure” that can be used as a forum to address potential double taxation problems resulting from two countries’ transfer pricing adjustments of a taxpayer. See, e.g., Rev. Proc. 91-23, 1991-1 C.B. 534, § 2.

215. See generally NONPAYMENT OF TAX, *supra* note 7, at 7.

A third observable difference in APA and non-APA results relates to the first, but is worth identifying separately—the reliance on treaty authority to permit APA participants to enjoy up-front certain rules not available under domestic law. The example noted earlier involved interbranch transactions which the United States traditionally has not recognized.²¹⁶ That standard U.S. tax position, however, can result in taxation that does not reflect the underlying economics. This problem is most severe in businesses that frequently rely on interbranch contracts—financial institutions engaged in global trading. For these taxpayers, the APA process represents an opportunity to get different tax rules applied to their global trading operations under the auspices of the Service's competent authority power from the treaties. Until the Service recently issued new proposed rules,²¹⁷ taxpayers not obtaining an APA had to treat their transactions under the existing framework. This is a clear case of the results available under an APA being undeniably different from those available through traditional avenues, but it is not inappropriate because in the parallel traditional stage, competent authority, other taxpayers could receive treatment predicated on the treaty.

Dissimilar results also can develop because of the different path for unilateral APAs and bilateral APAs. If APA negotiations involve one or more foreign countries who take a different “theoretical” view as to how to best approach arm's length pricing, there may be differences between bilateral APAs. In addition, bilateral APA results could differ from both unilateral APAs and from audit/appeals of similar situations. An example of this departure is seen in the negotiation of APAs with Japan. The U.S. APA office and competent authority have often viewed the comparable profits method as better suited than the profit split method to many cases involving related party distributors.²¹⁸ Japan, however, has argued for use of the profit split method. The different positions seem to reflect a combination of bottom line tax revenue expectations as well as opposing interpretations of the relationship between parent and subsidiary distributor: arm's length distributor for hire relationship v. partnership-like relationship.²¹⁹ For purposes of considering the results,

216. See *supra* text accompanying note 88. Recently, however, the Service released proposed regulations granting recognition to some interbranch transactions.

217. Proposed global dealing regulations, 63 Fed. Reg. 11, 177 (1998).

218. See generally Guttentag and Miyatake, *supra* note 36 (The United States seems to seek to limit the use of the profit split method because it is an internal approach that does not rely on third party transactions and data).

219. See, e.g., *id.* at 384 (“Japanese companies may rightfully be concerned that the use of U.S. companies as comparables could result in over-allocation of income to the United States, because U.S. companies generally may be more profitable The comparable profit

however, it is sufficient to note that in some of these bilateral Japan-U.S. APA cases, the countries have agreed to what has been termed a "hybrid method".²²⁰ Whether the hybrid method is considered pure compromise or an independent method with integrity, it is clear that the likelihood of obtaining this hybrid treatment from the United States in any other context (i.e., unilateral APA or non-APA process) is minimal at present.

The above analysis outlines the range of factors validly producing difference in APA and non-APA results: including "procedural efficiencies"²²¹ and comparison with the "wrong" stage in the process.²²² To the extent these have formed the basis of some concerns about negative impacts of the APA process on nonparticipants, they are unfounded. The APA process is a condensed (but not equal) version of a number of steps in the process, steps that typically occurred sequentially *ex ante* and *ex post*.²²³ Any residual dissatisfaction with differences produced by these factors must acknowledge that they are not unique to the APA program, but are pervasive in government enforcement action across fields. The existence of multiple levels of agency review often produces different results although such difference is not the goal. Additionally, the move from the domestic to the international realm frequently will lead to varying results.

Even if we concluded there should be no systemic reasons such as litigation risk or posturing (e.g. agents seeking large adjustments upfront in anticipation of settlement) for different results, it is not plausible or appropriate to expect the treatment emerging from the last domestic administrative stage (appeals in the tax context) always to be consistent with a case requiring international resolution. APAs form part of an international dialogue where some mutual agreement must be reached. All countries, however, do not share similar views, thus the accommodations that the United States reaches in each APA cannot

method ultimately forces a Japanese multinational group to realize as much profit as a U.S. multinational . . .").

220. See, e.g., Akamatsu, *supra* note 69. The use of the term "hybrid" here is different from the general use in this paper which identifies the APA program as a hybrid procedure.

221. As discussed in Part III, the change in participants and their roles in resolving transfer pricing issues was in part aimed at remedying potential conflicts inherent in the taxpayer/district dynamic. See *supra* Part III.A.1.b.

222. For example, comparing audit with APA fails to incorporate (1) the differences potentially due to the negotiation dynamic based on the role of audit versus appeal, and how that compares to the APA team, (2) the impact of treaty power on the Service's "ability" to accept results not clearly permissible under domestic law, and (3) the effect of the foreign country and its negotiating position on any final resolution.

223. The factors discussed above that contribute to difference are mostly due to comparing the APA process with traditional steps, short of the competent authority proceeding; thus, the role of the treaty or the other country is not yet factored into the non-APA side.

always be the same, nor can these accommodations always match the final U.S. domestic position (e.g. the appeals level determination).

2. Inappropriate Difference in Results

The remaining question is, what factors may be creating inappropriately different results? The answer is any departures or developments in transfer pricing reached in the APA program. That is, the real and relevant concern about results is a concern about the rules that taxpayers are facing before they enter into their transactions. For example, although the interbranch APA treatment was justified by the Service because the departure from existing domestic rules was based on treaty not purely the APA program, it is quite possible to imagine that less dramatic or obvious departures from existing rules occur independent of a treaty. Such departures may be less apparent to the extent that the current tax treatment is less clear. For example, treatment of foreign currency exchange or distribution subsidiaries may not be explicitly addressed in the current regulations, but a new understanding and practice may be developing at the APA level. In fact, one must presume this to be the case since the Service indicated it was considering producing issue specific guidance instead of redacted APAs. Unless the results are publicized, taxpayers not pursuing an APA have little assurance they will know of the "new views", or even if they know of them, that they will be able to convince audit and appeals they should apply.²²⁴ In fact, the audit and appeals officers themselves may not be fully informed of the APA developments. Under these circumstances, differing results would arguably be inappropriate.

Of course, how would a taxpayer know if results differ, and how could it prevent such differences? At a minimum, the answer to both involves disclosure. What a taxpayer needs to know is how it was treated in the traditional administrative process and then compare the results to similar industry APAs. If the APAs use a method or variation not available to the nonparticipant then there is a serious concern that the difference was inappropriate. What is the solution? Essentially, the same. If all taxpayers have access to redacted APAs, they can monitor on their own behalf and point out on audit what appears to be the "new" approach. This does not guarantee comparable or high quality results, but does (if respected) address major concerns of inappropriately

224. Although the main focus of APAs is future years, it is possible to rollback the results to earlier open years. See Rev. Proc. 96-53, *supra* note 12, at § 8. Part of the value of an APA, from the taxpayer's perspective, comes from the opportunity to get the audit level personnel involved in a dialogue with the National Office—and thus get them more comfortable with any new transfer pricing approaches.

different results. The pressure here for disclosure on the grounds of ensuring "equal treatment" of taxpayers is actually more complex than the term suggests. Implicit in a search for equal treatment is a desire to eliminate both accidental differences in tax treatment as well as those potentially motivated by misuse or abuse of power. But an additional value from disclosure occurs even when all parties' face comparable treatment. In that circumstance, disclosure still can play a critical function on a substantive law level. Disclosure opens the tax treatment and rules to outside scrutiny—from taxpayers, Congress, academics and the public. Thus, the pressure to eliminate "private law" should be seen to encompass claims for equality and quality in rulemaking.

C. Role of Disclosure in the Impact of APAs on Nonparticipants

From the above discussion of nonparticipants' two primary concerns about the APA program, the question of disclosure emerges. Ultimately, decisions about the disclosure of APA terms play a significant role in the effect of the program on nonparticipants and on the tax system more broadly. This issue of secrecy and disclosure confronts the degree to which the methods and results from individual taxpayer APA negotiations are made available to the public. At the outset, the Service maintained that the content of APAs was privileged taxpayer information subject to confidentiality under I.R.C. § 6103.²²⁵ Although the general participation statistics released by the Service as well as the random and occasional comments from taxpayers participating in the APA process provided some information on the scope and tone of the program, it has proven insufficient to satisfy the demand for the release of redacted APAs. Moreover, the nondisclosure policy in place through early 1999 led to the conclusion that APAs are creating a source of "private law."²²⁶ To the extent treatment is not publicly revealed, it may

225. See Rev. Proc. 91-22, *supra* note 12, at § 11; John Turro, *United States: IRS Official Says No APA Disclosure, But Generic Information to be Provided*, 4 TAX NOTES INT'L 709 (Apr. 6, 1992) (quoting IRS Associate Chief Counsel International, Robert E. Culbertson) [hereinafter Turro]; Stratton, *supra* note 58, at 138-39 (quoting the Service's view that APAs are not like other disclosed agreements, that disclosure would discourage participation because of the degree of sensitive information involved, and that a redacted APA would look "like a piece of Swiss cheese" and thus be unhelpful).

226. See, e.g., James R. Mogle, *Advance Pricing Agreements Under Revenue Procedure 91-22*, 45 BULL. FOR INT'L FISCAL DOCUMENTATION 356, 359-60 (July/Aug. 1991) (arguing that there is no support for the Service's position [at that time] that an APA and supporting documentation are tax return information, and warning taxpayers to be prepared for possible public disclosure of a redacted APA); Turro, *supra* note 225 (noting the concern that undisclosed APAs would lead to the development of a private law of transfer pricing); Mike McIntyre, *The Case of Public Disclosure of Advance Rulings on Transfer Pricing Methodologies*, 91 TAX NOTES INT'L 2-27 (Jan. 9, 1991) (expressing concern at the Service's

effectively constitute private law either because (1) it is not available in audit to taxpayers not pursuing APAs, (2) it is not sua sponte offered by the Service to other taxpayers seeking APAs, and/or (3) it is not available to taxpayers planning future transactions outside the APA process. Such a scenario would be most sensitive for taxpayers operating in the same industry where tax treatment is one factor which can provide a competitive edge.²²⁷ Disclosure, usually presumed to mean the release of redacted APAs, would alert taxpayers to their options, better assure consistency in the treatment of taxpayers, and contribute to a sense of fair play and openness in the tax system. It is possible to suggest, however, that rather than being harmed by nondisclosure, nonparticipants should be viewed as poised to obtain an unfair advantage if disclosure of APA terms is made because the nonparticipants would be able to free ride off of the time, effort, and expenditures of other taxpayers. This claim also would apply to the disclosure of letter rulings. The degree of undesirable free riding might be mitigated by (1) the absence of certainty when relying on another taxpayer's APA, and (2) the fact that if smaller companies are more likely to be the free riders, that benefit balances the burden of serious transfer pricing compliance costs on smaller taxpayers less able to bear such costs.

The Service's initial response to the concerns about nondisclosure was to establish a plan for the release of industry-wide guidance after a critical mass of APAs had been executed.²²⁸ As noted earlier, the Service

view that APAs are more like closing agreements, which are not disclosed, than letter rulings, which are published in redacted form). See *supra* notes 12 and 52 (describing the Service's change of view on the disclosability of APAs and the subsequent legislative response).

227. Another level of disclosure concerns (reminiscent of the history of letter rulings and rulings under I.R.C. § 367) considers the equitable treatment of tax advisors. The fear is that to the extent APAs are kept secret, those tax advisors (law firms and accountants) that are involved in APAs will have an advantage in retaining and assisting clients over those not already involved, solely because the agreements are unpublished. See generally, *Treasury Wanted to Prevent Agreements from Becoming 'Private Law'*, Lubick Says, 8 TAX MGMT. TRANSFER PRICING REP. 572 (Oct. 27, 1999) (hereinafter "Private Law") (Treasury Department wants to ensure that the "public and practitioners without specialized transfer pricing training were not being disadvantaged when they sought APAs."). Ostensibly, the government has no interest in some taxpayers being better advised than others, nor would it seek affirmatively to provide a profitable specialty to a limited pool of advisors. The degree of accessibility of the agency's decisions is a relevant factor in characterizing administrative action as rulemaking or adjudication. See, e.g., Shapiro, *supra* note 164.

228. See Turro, *supra* note 225. Despite the plan for more generalized releases, a major legal publisher filed a lawsuit against the Service in 1996, seeking release of transfer pricing methodologies contained in APAs, essentially seeking publication of redacted APAs. See *BNA v. IRS*, D.C. D.C., No. 96-CV376, 2/27/96. The publisher initially sought the information through a Freedom of Information Act (a "FOIA") request and a request under I.R.C. § 6110, both of which were denied; the former on the ground that the methodologies

changed its position and declared that APAs were "written determinations" covered by I.R.C. § 6110's disclosure rules, thereby prompting Congressional action to block disclosure and only require reporting.²²⁹ The question this section considers is whether this level of disclosure in the APA program is appropriate to meet equity concerns, given the effect on both the APA participants and the nonparticipants. In answering this question, it is important to consider what disclosure is normatively expected for various tax-related government interactions. With that baseline established, we can then consider what implications the hybrid procedural setting has for the ultimate analysis of disclosure. Related to this issue of equity is the view that transparency in an administrative regime is valuable as an independent goal regardless of its absolute connection to improved equity or outcomes. Thus, there may be additional grounds for higher levels of disclosure.

1. Disclosure Ex Ante and Ex Post

A review of the basic practices in the current tax system regarding disclosure, while not binding, provides guidance on expectations for disclosure. From tax returns to court proceedings, there is a spectrum of disclosure treatments which, taken together, suggest an underlying policy. An important caveat must be acknowledged regarding disclosure. Although general norms and baselines can be ascertained from the operation of the existing income tax system, we still lack a comprehensive normative picture of the basis for and contours of privacy in a regulatory regime. Nonetheless, the basic scope of the

constitute confidential return information and contain confidential taxpayer information, the latter on the ground that APAs are confidential documents protected from public disclosure. Following the December 1999 amendment to I.R.C. § 6103(b) preventing disclosure of APAs, BNA and the Service agreed to the dismissal of the suit. See "BNA, IRS Agree to Dismiss Lawsuit Seeking Access to Redacted APAs," 8 TAX MGMT. TRANSFER PRICING REP. 740 (Jan. 12, 2000).

The effort to force disclosure of APAs parallels the battle in the early 1970s over letter rulings, which at that time were not disclosed to the public. Two lawsuits were filed and ultimately the courts of appeal for the District of Columbia and the Sixth Circuit found the letter rulings to be subject to disclosure and not protected as tax return information under I.R.C. § 6103. See SALTZMAN, *supra* note 54, at 3-30; *Tax Analysts & Advocates v. IRS*, 505 F.2d 350 (D.C. Cir. 1974); *Freuhauf Corp. v. IRS*, 522 F.2d 284 (6th Cir. 1975), vacated and remanded for reconsideration in light of the Tax Reform Act of 1976, 429 U.S. 1085 (1977). The issue of disclosure was finally addressed by I.R.C. § 6110, enacted by Congress in 1976, which was intended to serve as the exclusive remedy for disclosure of rulings and related material. See I.R.C. § 6110(l); General Explanation of the Tax Reform Act of 1976, at 304 (Comm. Print 1976), *reprinted in* 1976-3 C.B. (Vol. 2) 316. I.R.C. § 6110 generally provides for the disclosure in redacted form of any "written determination," that is, a ruling, determination letter, or technical advice memorandum. See I.R.C. § 6110(a),(b)(1).

229. See *supra* note 12.

disclosure question can be evaluated by accepting the apparently existing parameters for disclosure and then considering their treatment in the APA context. To the extent a new or different fundamental theory of disclosure is advocated, it would require an independent argument on the principles governing disclosure.

In *ex ante* interactions, the pattern is to provide significant disclosure, except for taxpayer identifying information (including names, dollar amounts, specific industry activity, etc.). This makes sense because the interaction, typically some type of ruling, is establishing a rule or interpretation. There is no litigation risk factored into the analysis;²³⁰ nor is there a dispute over facts (i.e., they are assumed). Given the prospective nature of such advice, a lesser disclosure policy would not only invite criticism, but the actual creation of private law. Rules to which we hold taxpayers should be public to ensure notice and equal application of the law. At the same time, however, continued secrecy or privacy for the taxpayers' specific details seems appropriate.²³¹ Publication of such current financial and business information could put the taxpayer at a significant competitive disadvantage as compared to others in its industry both domestically and globally. Furthermore, it might deter taxpayers from seeking guidance from the government at the most useful point—before transactions have occurred. Both the particular taxpayer and the Service can benefit from this up-front clarification.

Ex post, from tax returns to appeals, there is typically no disclosure of the taxpayer-government interactions. Again, a rationale can be discerned from the pattern: for these generally backward looking interactions (with no guarantees of future treatment)²³² there is much less

230. Litigation risk is understood here to refer to an effort to ascertain one's chance of prevailing in court in a given case in light of the particular facts and circumstances and their relation to the rules. If a much broader conception of "taking litigation risk into account" were used, then essentially all functions of an administrative agency like the IRS would be said to include consideration of such risk. That is, even when a regulation is issued, the Service is aware that such a regulation could be challenged in courts. Similarly in the context of the APA program, it could never be said that the results were reached without any thought to how alternative IRS positions would fare in court. But litigation risk as used in this broader sense is more a function of the fact that every action by an administrative agency is ultimately reviewable in court.

231. See, e.g., Stratton, *supra* note 58, at 139–40 (outlining taxpayer claims for disclosure that nonetheless are sensitive to the need not to reveal confidential taxpayer information).

232. There are exceptions such as closing agreements. See, e.g., 14 MERTENS LAW OF FEDERAL INCOME TAXATION § 52.03 (1997) ("A closing agreement is a written agreement between an individual and the Commissioner which settles or 'closes' the liability of that individual (or the taxpayer or estate for whom he acts) . . . A closing agreement may relate to tax liability for a past taxable year or relate to specific items in past or future years.").

information of valid and significant use for other taxpayers, particularly when balanced by the risk to the taxpayer at issue from the disclosure. For example, tax returns contain current business data and the taxpayer's own legal conclusions. Neither should play an important role in others' tax planning.²³³ And although the settlement at appeals does in fact establish a taxpayer's tax treatment (and involves the same data at a less "contemporary" point in time), its general relevance is somewhat limited. The settlement reflects not only the facts and legal rules, but also the Service's assessment of its own litigation risks. Litigation risks (including the context of the issues and the precise facts) vary from case to case, so a settlement reached at this level has less bearing on other taxpayers, and certainly no precedential value. That does not mean disclosure would be of no valid interest to other taxpayers. Disclosure of audit settlements would give taxpayers the ability to evaluate and predict the Service's behavior in audit. Nonetheless, a stronger argument can be made for why disclosure at this stage should be limited.

In litigation, the fact that most taxpayer information may be released in the form of court opinions and other litigation documents reflects the difference between internal agency settlement and the adjudicatory process through the courts. Settlement is more context specific because of the inclusion of litigation risk. However, litigation risk has no place in judicial decisions. The tax system expects and requires compliance with the rules and it is that compliance which is assessed at trial. That factor alone would be insufficient to explain the degree to which taxpayer information is disclosed in cases. Clearly other factors are at work, including a powerful vision about the importance of a public judicial process, as well as the likelihood that taxpayer data revealed in a case will usually be at least several years out of date.

Thus, although the APA program's disclosure policy is not bound by the particular treatment of any current disclosure pattern, the tax system's disclosure practices seem to focus substantially on the ex ante/ex post line as well as the degree of negotiation and risk assessment involved. Where the government exercises primarily legal decision making authority (i.e., it is not negotiating) the demand for disclosure is strong. Conversely, government action premised in part on other factors (e.g., in settlement negotiations) presents a less compelling case for disclosure. Thus, a taxpayer's first interactions (letter rulings prior to the

In practice, the agreements reached in audit may provide some indication of what will be acceptable in the future. However, where the agreements are based extensively on compromise of issues and risk they may be less useful.

233. Moreover, protection of a taxpayer's contemporary data (i.e. the return information) might enhance compliance with the tax laws.

transaction) and last interactions (judicial decisions) with the government are the ones in which disclosure is expected. Both focus on the legal issue without regard to other aspects of negotiation and litigation risk. In addition, both represent a final stage—the letter ruling as the last word on taxation prior to the transaction, and the judicial decision as the final word after the transaction.

2. Disclosure in the APA Procedure

Turning to the APA context, direct application of the *ex ante/ex post* perspective combined with an eye towards the nature of the government role would require disclosure of APA terms with necessary redactions. APAs are forward-looking arrangements that produce more finely tuned specifications of the law prior to the transactions. As the law is being refined and developed, such information should be available for all taxpayers evaluating the potential impact of future action. Anything short of “full application” of the law should not be granted in advance to some taxpayers and not others. In such a case, two separate taxpayers seeking to comply with the rules will in good faith conduct their transactions very differently, and each will be correct because their laws are different.

At the start, the government must spell out the law to be applied and the taxpayers must strive to apply it. After the fact, greater uncertainty arises because of issues of proof. If these uncertainties ultimately lead to different results for taxpayers it should be less problematic because each taxpayer took a risk in conducting itself and filing a return short of the “law.” Each taxpayer adopted a stance with no guarantee of different treatment and risked the results.²³⁴ Even if the discrepancies in taxpayer treatment in settlement are due to human inconsistency, and not assessment of litigation risk, that variation is less serious than variation

234. A very rough analogy to criminal law that may shed some light on this conception of the past/future distinction is the role of the plea bargain. On the books, various crimes carry specified penalty ranges. However, after a person has committed a crime, it may be possible to plea bargain to a lesser offense and reduced penalty. This scenario is accepted because the government in each case must confront its litigation risks and resources. It would not, however, be possible (nor conceivable) to allow individuals to approach the government before committing a crime and reach an up-front agreement as to some lesser crime and penalty for which the individual if caught would be charged and sentenced. Obviously, the parallel to the tax case is limited. First, disclosure is not an issue in the criminal context because the plea agreements are made public. Second, the tax disputes at issue are civil administrative disputes with the government and typically involve basic transactions that are permissible in some form. Nonetheless, the analogy helps capture the visceral sense of a distinction between the appropriateness of the variability of the rule of law before and after the relevant actions have been taken.

in the ex ante statement of the law because it does not provide one taxpayer a predictable advantage over another.

Although direct application of the tax system's disclosure practices would seem to require release of redacted APAs, the question remains whether anything special about the APA process would support nondisclosure. Interwoven in the debate regarding disclosure in the APA program is a competition among several administrative values including improved rulemaking, facilitation of international cooperation in regulatory regimes, and the independent value of transparency. Several arguments can be made that full disclosure, with redaction of the barest taxpayer identifying details, would not be appropriate in the APA process. First, the nature of the subject matter makes it impossible to provide meaningful APA disclosures while simultaneously protecting the taxpayer-specific data contained in the APA. This is the "Swiss cheese" point previously made by the Service—that APAs are not like other agreements and a redacted APA would look "like a piece of Swiss cheese" and thus be unhelpful.²³⁵ Therefore the plan to release either industry or issue based advice was viewed as an effective mechanism for conveying current Service thinking and approaches on transfer pricing without releasing individual data. This position, however, is not dispositive. If disclosure would fail to achieve certain critical results (e.g., equity, transparency), then the risk posed by the program could be determined to be so severe as to warrant its rejection in the absence of an another disclosure solution.

However, to the extent transfer pricing guidance tends to be context specific, generalized guidance may be insufficiently detailed to adequately inform taxpayers, and context may be difficult to provide while protecting "privacy". The standard view is that the core APA agreement is relatively boilerplate and the real information, and power, resides in the attachments specifically applying the treatment to the taxpayer's situation. Even for taxpayers reasonably satisfied with the level of detail provided in a release like Notice 94-40, the pace at which such releases are being issued renders them more of a theoretical than actual alternative. To date, Notice 94-40 (and the subsequent 1998 proposed global dealing regulations) has been the only release of its type. Moreover, the Service has indicated that it is moving away from "industry-based" guidance,²³⁶ which is how that notice could be

235. See Turro, *supra* note 225, at 709 (quoting comments of IRS Associate Chief Counsel International, Robert Culbertson); Stratton, *supra* note 58, at 138–39 (quoting Service views on the value of disclosed APAs).

236. Apparently some industries had initially expressed interest in pursuing an "industry-wide" APA. See Kathleen Matthews, *U.S. Branch IFA Meeting Highlights Cross-*

characterized, and may focus on issue-specific guidance, such as the treatment of currency exchange, distribution subsidiaries, and location savings.²³⁷

The lengthy period between drafting and releasing a notice is understandable from the perspective of an administrative agency. Releases outlining the Service's approach to a problem cannot be quickly drafted and published; they must be evaluated for their overall conformity with the system. That administrative delay merely enhances the appeal of disclosure of redacted APAs—once the APA is finalized for the taxpayer, the only additional step necessary for disclosure is to redact the appropriate information. Although there may be some delay due to debates over what is and is not redacted, one anticipates this process could be handled more expeditiously than release of a notice. In addition, to the extent the APA program is part of an evolving process, the notices may be significantly outdated by the time they are issued.²³⁸

The second argument that disclosure in the APA program cannot be the same as disclosure usually made for ex ante government interactions is premised on the “source” of the program's success—its flexibility, its ability to take a very contextual look at transfer pricing. The contribution and value of this type of case-by-case development in transfer pricing presupposes the flexibility to tinker with the system in each new case. If disclosure were expected to reduce the APA office's sense of flexibility and creativity in approaching transfer pricing, it would detract from this major benefit of the program. But what is the current source of flexibility and why would it be diminished through disclosure?

Border Corporate Reshufflings, Tax Treaties, APAs, 8 TAX NOTES INT'L 776, 780 (1994) (then-APA Director Robert Ackerman reporting that the Service was “working with several taxpayers' groups to identify the appropriate industry to develop a generic industry-wide APA approach.”). For a variety of reasons, including cost and collective action problems, the pressure for that has declined. Similarly, the APA office has concluded that global trading and financial instruments aside, which it views as a unique circumstance, the situations of industry members are too varied to make that kind of guidance useful. See Shaughnessy, *supra* note 136, at 406 (then-APA Director Michael Durst stating that “[w]ithin an industry, every company's situation differs and there would be no way of doing an industry-wide APA,” but suggesting they would try more guidance like Notice 94-40). Instead, the APA office expects that developing treatments of recurring issues like currency exchange and distribution subsidiaries would provide more informative guidance. See *id.*

237. See generally Stratton, *supra* note 58, at 138–40 (noting shift away from industry guidance to issue-specific guidance).

238. This observation would not necessarily imply that APAs themselves are out of date. The typical term is about three years, whereas it may take a while to feel enough perspective has been gathered to release a notice. See, e.g., Rev. Proc. 96-53, *supra* note 12, at § 5.09(1) (suggesting sample term of three years). Thus, APAs can be incrementally improved, but a Notice may be a less flexible format.

The flexibility itself may derive from several sources: (1) given bilateral APAs are predominant, most APA negotiations are done under the umbrella of treaties and the broad discretion they grant the competent authorities to resolve issues of double taxation, (2) the continued availability under the new transfer pricing regulations of unspecified methods,²³⁹ and (3) the effect of secrecy in limiting a taxpayer's ability to rely on prior APA terms to claim the same treatment. As to the first two points, their impact in promoting a flexible approach would continue unchanged if APAs were disclosed. As to the last point, one might argue that evolving flexibility is legally permissible, and thus, if the APA office wants to change course it should not be reluctant to say that we have changed our prior approach because of an improved understanding in this area.

The concern here about disclosure, however, may reflect a more sensitive and realistic assessment about the crystallizing effect of disclosure despite the propriety of the Service's affirmative use of the process as a creative laboratory; there is an inherent implausibility of continued flexibility in a public forum. Also, foreign governments may be hesitant to place themselves in the position of confronting taxpayers who treat redacted APAs as virtually binding authority, rather than as simply offering insight with no precedential value. This concern might be satisfied by not specifying the foreign country in a reacted APA.

The third argument against even redacted disclosure is the possibility that many taxpayers would not pursue an APA under such terms, and without adequate volume the broader benefits of the program would be limited.²⁴⁰ This contention is unprovable until tried. Of course, many taxpayers who have already completed the process would, if asked, most likely indicate disclosure would have been a serious factor weighing heavily, if not dispositively, against an APA. Even taxpayers seriously considering an APA might express such views if they expect the benefits of secrecy for their future APA to be greater than the present benefits of additional data on the APA program. However, taxpayers who are much less certain of seeking an APA, or who perhaps have

239. See, e.g., Treas. Reg. § 1.482-4(a), (d) (outlining use of methods not otherwise specified in the regulations to evaluate arm's length pricing in the transfer of an intangible).

240. See generally Stratton, *supra* note 58, at 138-40 (quoting various former IRS officials regarding the role of nondisclosure in trying to attract participants to the new program and the view that even now a policy of redacted disclosure would make a difference to taxpayers at the margin and might counsel against an APA); see, e.g., *Practitioners Say More Countries Will Enter into APAs in Future*, 1996 DAILY TAX REP. (BNA) No. 171, at G-5 (Sept. 4, 1996) (identifying potential disclosure of sensitive information and trade secrets as a serious concern for Chrysler Corporation in considering an APA, especially in an industry where there are only three big U.S. automakers).

decided against it, would seem to have much more to gain from disclosure. In terms of taxpayer reaction to disclosure, early applicants may have been particularly concerned about disclosure in an otherwise new and untested program.²⁴¹ Now taxpayers may be more relaxed in this mature, although evolving, program. Also, the implementation of the documentation requirements and penalty rules have added an additional boost to the appeal of the APA program guaranteeing a stream of participants.²⁴²

A final argument that seeks to minimize the call for disclosure in APAs contends that anyone worried about “private” or “secret” law in the APA context should be worried about it more extensively (i.e., in examination and appeals, where resolutions are not made public).²⁴³ Certainly the risk has always existed that taxpayers are not receiving “similar” treatment in audit or appeals (i.e., the Service could be “playing favorites”).²⁴⁴ However, this risk in the APA context differs because the taxpayer-Service interaction occurs *ex ante* and the relationship lacks the same negotiation and risk assessment evident at other stages. The APA provides the taxpayer participant not just with “special treatment,” but “special treatment” that is guaranteed before the taxpayer takes the risk of engaging in the transaction.

3. Assessment of APA Disclosure

Disclosure policy in the APA program forms a direct link between the impact of the program on participants and nonparticipants. Depending on the policy adopted, the effectiveness of the program shifts: the more limited the disclosure, the more attractive the program is for participants, and thus, the more likely it is to be a successful alternative for such participants. Limited disclosure, however, poses risks for nonparticipants in terms of their ability to evaluate the equality of rules imposed and the comparability of results achieved through the APA and non-APA processes. It poses risks more universally in terms of the limited scrutiny afforded transfer pricing treatment and developments. Because the APA program must be understood as an alternative procedure that is part of a larger interconnected tax system,

241. See, e.g., Stratton, *supra* note 58, at 138–39 (former Associate Chief Counsel International Robert Culbertson stating that one reason for the confidentiality aspect of the APA program derived from the Service’s desire to encourage taxpayer participation in a new program that required such participation to provide sensitive business information to the government).

242. See *supra* note 116.

243. See, e.g., Stratton, *supra* note 58, at 138 (citing former Associate Chief Counsel International Robert Culbertson’s view that any such fears should not be limited to APAs).

244. See *id.* at 139.

the impacts on both participants and nonparticipants are critical. The question then is how to strike that balance.

Rules, modifications, and developments made available to a taxpayer before entering into a transaction should be available widely, and the best way is to disclose the treatment. Taxpayers will then face comparable tax risk going into their transactions. The APA interaction is before the taxpayer's transaction and therefore changes the taxpayer's risk. As a result, the APA's terms should be disclosed unless the ex post elements of the program raise serious opposing concerns.

Attention to the ex post features of the APA program could suggest that the price of disclosure is too high because it inevitably would require disclosure of contemporaneous taxpayer information. Such disclosure would put the taxpayer at a disadvantage with respect to its competitors. This ground, with its implicit balancing or cost-benefit approach, cannot stand separately from a specification of the particular form of disclosure made. At the extreme, disclosure of a very heavily redacted APA (with exclusion of the identity of the foreign country) should be possible to protect trade secrets, financial data, and market strategies of the APA participant. The real concern, therefore, must reside in the expectation that "completely Swiss cheese" redacted APAs would offer so little guidance that public demand for information would ultimately lead to disclosure of APAs according to less stringent redaction standards. This conflict is not usually faced in the traditional ex ante function of developing rules because no individual taxpayer's facts are used to define the rule.²⁴⁵ Except for the interbranch and global trading APAs, the specification and elaboration of the method may be intimately connected to the APA participants' facts, transactions, and data. Arguably, trying to express these applications of transfer pricing divorced from their factual context may be difficult.

Although there is little disagreement as to the basic contention that rules proffered ex ante (i.e., before the transactions are done) should be publicly available, the real issue is the implementation of this in a hybrid procedure like the APA. Satisfactory resolution of this balancing question has been impeded by (1) the absence of even heavily redacted disclosures, (2) the absence of substantial other guidance (e.g., notices on industries, issues, or methodological points), and (3) the one sidedness of information (i.e. those advocating disclosure generally lack

245. Although letter rulings are issued based on a particular set of facts provided, the requirement that the legal question be relatively clear on the facts means that the precise details and contours of the facts are not that critical. Thus, a highly factual and contextual legal question like transfer pricing is not considered appropriate for a letter ruling. *See supra* text accompanying notes 56–58.

exposure to a significant number of APAs, and are asked to accept the conclusion that it is impossible in most cases to reduce APAs to meaningful, yet data protective, documents). Based on the considerations outlined, disclosure of redacted APAs seems required. To the extent their "Swiss cheese" nature would render them less than illuminating, the Service could complement their content with more explanatory general guidance.

What then should be made of the current situation in which Congress has implicitly approved the APA program for the present, but has statutorily preempted any effort by the Service to disclose individual, redacted APAs? The legislation limiting disclosure and calling for annual APA program reports resulted from taxpayer fears of the release of redacted APAs. Thus, one anticipates that these reports will constitute less complete disclosure than would have been available under the Service's disclosure plan. Such a conclusion, however, is not inevitable. Congress specifically detailed the information required in the annual reports, including APA statistics; general descriptions of businesses, transactions, and functions covered by APAs; methodologies used to evaluate transactions; critical assumptions made; sources of comparables used; and nature of adjustments made to comparables.²⁴⁶ Depending on the level of information provided, such aggregate data could offer more concrete guidance regarding appropriate transfer pricing analysis than heavily redacted APAs. Although the fact that APA participants prefer reports over redacted APAs suggests the reports will be weaker, a true comparison of information released would require seeing sample redacted APAs.

In this disclosure discussion, however, an underlying tension must be confronted in order to evaluate the realistic prospects of a disclosure plan. A tension exists between the explanation for why transfer pricing is difficult and the explanation for why disclosure is useful and plausible. On the one hand, the claim is that transfer pricing is fact intensive and not susceptible to quick and easy rules. On the other hand, some kind of disclosure is sought as a mechanism for providing guidance to taxpayers generally. If it is hard to resolve transfer pricing cases in a rule oriented fashion, how can any useful, aggregate information emerge from APAs? There are two facets to this problem. First, is it possible to have sensible, predictable, coherent rulemaking here—can APAs be more than ad hoc bargains? The answer should be yes, on a relative scale. That is, although the importance of facts may make complete uniformity of

246. Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. No. 106-170, § 521(b)(2), 113 Stat. 1860 (1999).

outcomes difficult (one can think of other areas where this arises, such as questions of whether a payment is a gift, or whether a security is debt or equity), it should be possible to help clarify relevant factors and approaches. In theory, the Service could issue such guidance in the absence of the APA program. One reason this may not have occurred is the Service's need and desire to obtain a more comprehensive picture of particular transfer pricing scenarios and issues first. A format that entices taxpayers to be forthcoming with information is most useful in that capacity. Another reason such non-APA guidance may not have been prepared is that any unilateral issuances not developed in conjunction with other countries would be of limited value. They would not reflect the other country (or countries) involved and might not even represent the Service's final position that would emerge from ultimate dealings with the foreign country.

Second, on a more practical level, what APA "answers" will we see following the implementation of the required APA reporting? The Service, though desirous of providing guidance to improve transfer pricing compliance, also wants the opportunity to develop this area without being held too strictly to errors or changed judgments.

Even with Congress taking the decisive step to permit only APA program reporting, other countries participating in the APA program may resist.²⁴⁷ These countries could bar disclosure of information either under their treaties with the United States, or as a condition to their participation in the program.²⁴⁸ The United States could, of course, complete bilateral APAs only with countries willing to permit disclosure, but this route could produce limited participation levels. In essence, the success of the APA program relies on participation for two reasons. First, the program is most beneficial when all of the relevant countries to a transaction are involved. As discussed earlier, although unilateral APAs are occasionally appropriate, bilateral APAs are usually the most valuable. Second, a major advantage of the APA program is the expanding knowledge and experience base it offers the Service. This requires a large pool of APAs, and anything that limits the number of participating countries would inevitably limit the number of APAs.

247. See generally *Private Law*, *supra* note 227. Confidentiality may also be critical to other countries who have legitimate concerns to protect their interest.

248. See, e.g., "President Signs Law Clarifying APA Confidentiality Policy, Mandating Study," 8 TAX MGMT. TRANSFER PRICING REP. 710, 710 (Dec. 22, 1999) ("For the future, taxpayers and treaty partners will determine before an APA is completed which portions of it they wish to redact . . . [f]or example, if a treaty partner were to insist that no information on transfer pricing methodology be revealed, the Service would not include that information in its report.").

Alternatively, if the United States were unwilling to limit the participating countries to those accepting disclosure, it instead could have viewed the program as purely an interim function and, for the limited window of its operation, continued to tolerate the tension created by nondisclosure. By not taking this path (and by announcing its intention to disclose), the Service may have been indicating its view that the APA program should serve as more than a short term institution, and its belief that other countries can be persuaded that such disclosure policies are sensible. The United States has been successful in shaping and influencing the views of other taxing jurisdictions on a variety of issues. If disclosure is an important part of a well functioning APA program, the Service may be willing to promote that position. The recent Congressional action in this area, however, renders such advocacy futile for the present.

The question remains whether disclosure through annual reports could be a sufficient remedy for the problems outlined above in subparts A and B. Three major concerns continue: (1) inadequate disclosure; (2) failure to change Service behavior (i.e. a “so-what” response to discrepancies); (3) a more subtle difficulty in persuading the Service that there is a difference between the reports and the particular taxpayer’s treatment (for example, some of the same factors that made transfer pricing a challenging issue could make it hard for taxpayers to convince the agent (audit level) that a particular treatment outlined in the APA report should be “applied” to their situation). The original problems with transfer pricing may be serious enough to encourage acceptance of a less than perfect procedural option. In addition, other observations may mitigate worry over reliance on disclosure. First, as discussed above, disclosure is not an on/off switch, but a spectrum. It may be possible to tinker with the form and content of the reports to improve their usefulness. Second, two “back-stop” options exist, one for participating taxpayers, one for nonparticipants. If the Service behaves unreasonably aggressively in the APA process, taxpayers need not participate. Alternatively, if the Service’s APA positions are “too” easy relative to usual audit treatment, the Service will be inundated with participants (although it is not clear what the “right” number of participants should be). Taxpayers not participating can turn, as a last resort, to the courts to challenge the Service’s more stringent audit positions. Third, Congressional oversight looms large for the Service. The tax system has been the focus of recent sweeping legislative inquiry and action to address inefficiencies and abuses.²⁴⁹ Such legislative involvement is a

249. See *supra* note 3.

draconian, though powerful, constraint on general trends of abuse by the Service. Finally, we can push for more explicit guidance for audit and appeals from the APA process beyond the reports (for example more notices, rulings, and regulations).

Ultimately, one intangible effect of the nondisclosure position will continue to haunt the program. Even if the APA annual reports prove robust, the literal fact of secrecy regarding actual negotiated agreements helps harbor doubts about equal and consistent treatment in the program. Regardless of the true facts, the lack of transparency can undermine any program's claim to legitimacy. For the moment, Congress has made the assessment that this balance of disclosure and secrecy represents an appropriate trade off. Whether the choice withstands the pressure for information will depend in large part on the quality of the reports.

D. Assessment of APA Program's Impact on Nonparticipants

The focus in Part IV has been on the collateral effects of the APA program: (1) whether there are inappropriate participation differences that create advantages for some taxpayers, and (2) whether APA results that differ from audit and appeals demonstrate an inappropriate advantage to APA participants. The analysis turned in part on the *ex ante/ex post* distinction and the role of the particular government body involved. What constitutes acceptable participation or comparable results depends on the point in the tax system under consideration.²⁵⁰ Ultimately, the conclusions for both questions were linked by the role of disclosure. Although access and participation in the APA program is relatively open and improving with the efforts to draw in smaller taxpayers, "participation" in the new rules is weak because of disclosure. Similarly, despite some valid explanations for differing results, the concern remains that something like the special treatment of interbranch transactions exists²⁵¹—different rules available up-front for APA participants. Better reporting may alleviate this continuing suspicion as well as facilitate the dissemination of emerging (though not binding) views.

250. As to the question of the scope of "participation" in the process, one could counter that cases pronounce rules, and that only the immediate taxpayer can participate. Although this description is accurate, the full comparison is not. The *ex ante/ex post* emphasis on a level playing field is still maintained. Everyone engaging in the transaction before the court decision faced the same rule (and its same potential for varied interpretation). After the decision, all new transactions are subject to the new rule. Thus, although direct participation in the establishment of the rule is not universally open (in part because that is an adjudicatory procedure, not an administrative one), the goal of equal risk is preserved.

251. But without the treaty based justification for difference. See *supra* text accompanying notes 158–159.

This examination of the troubling features of the APA program commenced by delving deeply into APA process and its relation to the tax system. Assessment of the program's usefulness necessitated such a specific inquiry. However, this undertaking is more than a case study in taxation. Both the problems that prompted the creation of the APA program and those raised by its implementation tell a story about administrative regulation that transcends tax, and speaks to universal issues in administrative law. Fundamental conflict exists between the traditional framework of administrative law (a structure based on rulemaking and adjudication) and the demand for creative solutions to problems experienced in many regulatory fields. The establishment of new rules through an adjudicatory process is usually acceptable if transformed into precedent in accordance with the rulemaking and adjudication pattern. However, the APA program's decisionmaking does not produce precedent in the classic adjudication model, nor does it conform to the model of classic rulemaking. The APA program's "hybrid" nature, its very departure from the traditional models so critical to its success outlined in Part III, helps explain the problems identified in Part IV. They are the obvious result of a clash between the value of an administrative system which declares its rules up-front and the value of a flexible administrative process that permits learning, experimentation, and testing.

Procedural innovation in tax is not the only example of conflict—similar creative, flexible developments in the environmental area pose comparable problems. For example, Project XL implemented by the Environmental Protection Agency ("EPA") allows a company to negotiate a comprehensive permit (possibly making tradeoffs among various emissions). The permit program focuses on providing extensive information to the government, predicting results, testing the actual conditions, and then updating terms based on the new information.²⁵² Flexibility in this individualized process is expected to generate creative, superior solutions. Although the format of Project XL includes a broader range of participants than the APA program, including community groups, their impact on the process and results has been questioned.²⁵³ Another EPA program, the "Brownfields Economic Redevelopment Initiative" allows the "prospective purchaser of contaminated property" to reduce its liability if it pursues voluntary, satisfactory cleanup, the extent of which can be negotiated.²⁵⁴

252. See Freeman, *supra* note 1, at 55–56.

253. See *id.* at 56.

254. See Breger, *supra* note 1, at 333–34.

In the language and discourse of administrative law, the dangers posed by such flexible administrative processes are captured under the rubric of accountability for administrative agencies—controlling discretion.²⁵⁵ Accountability and discretion issues lie at the heart of the APA disclosure debate. They also play a prominent role in critiques of the EPA initiatives.²⁵⁶ Various forces, including regulatory capture, can lead agencies astray in exercising their discretion, especially if agencies and regulated industries are negotiating alone.²⁵⁷ Not only does disclosure constrain discretion and limit regulatory capture, but in the APA setting, foreign countries perform this function as well through the exercise of their often powerful self interests.

Flexibility in an administrative regime can be messy, as demonstrated by the APA program. However, we may better understand and improve such innovations through a detailed knowledge of their operation and an appreciation of the connection of their problems to the larger themes, goals, and tensions in administrative law. The effort to facilitate flexible regulatory process makes sense, especially in an international context where the global implications are substantial and the likelihood of conflict is high.

V. THE APA PROGRAM AS A CASE STUDY FOR ADMINISTRATIVE LAW THEORY

At the outset, this paper made the claim that a case study of the APA program was not only critical in evaluating the innovation's role in the tax system but also could enhance the dialogue and debate surrounding administrative law. There are two levels on which analysis of the APA program may be beneficial: (1) on a broad theoretical level the APA program can illuminate the usefulness of the overlapping and competing theories of the administrative system by testing each against the experience of the program, and (2) on a more functional level, the APA program's creative origins and its current operation offer guidance on the programmatic benefits of various types of flexibility in

255. See Freeman, *supra* note 1, at 82.

256. See, e.g., Breger, *supra* note 1, at 335 ("Making regulatory agreements more 'individualized', however, makes it less likely that consistency will be achieved and general standards followed").

257. See, e.g., Freeman, *supra* note 1, at 81 (noting that a "collaborative model that includes only agencies and industry" would likely draw the attentions of regulatory capture fears); see, e.g., Ian Ayres & John Braithwaite, *Tripartism: Regulatory Capture and Empowerment*, 16 L. & SOC. INQUIRY 435, 438 (1991) (discussing factors producing agency capture).

administrative systems generally. Thus, this Part divides the administrative inquiry into two directions. The first focuses on three basic theoretical frameworks used to analyze administrative systems and their functioning (public choice, neopluralism, and public interest). The validity and applicability of one theory over the others would be important in contemplating reform. However, failing the ability to identify a dominant theory, we may nonetheless discern conditions under which a given theory is more or less relevant. Regardless, these often abstractly considered theories require real world testing.

The second direction examines administrative theories (civic republicanism and collaborative governance) whose vision of administrative process centers more explicitly on facilitating reform and innovation through redefining relationships. Even if the normative aspects of these approaches, in particular their rejection of interest group representation as a pivotal feature of administrative law is overstated, the value of emphasizing new ways to structure administrative relations remains.

Making the leap from a discussion of the APA program anchored in the tax literature to one linked to administrative law debates is more feasible than might be thought initially. While administrative law discussions typically do not focus on tax examples, and tax analyses typically are not undertaken against an administrative law backdrop, the questions about the APA program pursued in this paper parallel questions posed generally in thinking about the administrative system. The major issues include how to understand the dynamics and effects of an existing process and how to think about change and innovation. Although this section will not purport to offer a comprehensive analysis of the intersection of the APA case study with administrative law theory, it is appropriate and useful here to try to sketch those connections in some detail.

A. Forum for Testing Administrative Law Theories

The first step in using the APA program as a testing ground for administrative law is to outline the current picture of the theories in question. Obviously such a description is a shorthand and not inclusive of the numerous variations of the different models. Moreover, the goal is not to demonstrate the complete relevance or irrelevance of a given theory, but rather to use a case study to advance understanding in at least two ways: (1) by revealing the complexity of administrative law analysis within a single example; and (2) by indicating directions for the

expansion and development of the theories.²⁵⁸ Three general theories of regulation and the administrative state can be identified: (1) public choice, (2) neopluralist, and (3) public interest. These theories share a common foundation in their view of the function and significance of interest group behavior.

The first theory, public choice, begins with the understanding that administrative law and regulation are justified in part on the ground that such efforts respond to the "market failure" in providing necessary rules or outcomes in the absence of the administrative state.²⁵⁹ The theory then concludes that the administrative state generally is unsuccessful at repairing this market failure and instead is providing regulatory benefits to well-organized political interest groups which benefit at the expense of the general public.²⁶⁰ The second theory, the neopluralist, is similar to public choice in that it also places organized interest groups at the center of the regulatory process. Neopluralism notes the dominant role that interest groups play in setting regulatory standards but concludes that their competition produces results very roughly reflecting the general public interest as a whole.²⁶¹ This competition oriented picture takes the process and the results to be less imbalanced than the public choice theory and thus is less critical of the regulatory system.²⁶²

258. In providing this overview, the paper relies in part on the recent work of Steven Croley which seeks to take a more global and comprehensive look at the range of theories and their relationship to each other and to the administrative process. See Croley, *supra* note 1; see also Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 168-69 (1990) (outlining the classical public interest theories and the opposing theories premised on special interests and regulatory capture).

259. See generally Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974) (describing a "public interest" theory as adopting the view that regulation is supplied in response to public demand to correct market failures); Sam Peltzman, *Toward a More General Theory Regulation*, 19 J.L. & ECON. 211, 212 (1976) (under certain models "the existence of market failure is sufficient to generate a demand for regulation"). To the extent the theory is normative in terms of justifying the creation of the regulatory state as opposed to positive in highlighting how such a state operates, it has less direct relevance to distributive and redistributive regimes such as social security and taxation. See Croley, *supra* note 1, at 4 n.7.

260. See Croley, *supra* note 1, at 5; see generally, William C. Mitchell & Michael C. Munger, *Economic Models of Interest Groups: An Introductory Survey*, 35 AM. J. POL. SCI. 512, 517 (1991); Peltzman, *supra* note 259, at 212-13. But see, e.g., Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 TEX. L. REV. 873, 895-900 (1987) (reviewing empirical studies and suggesting the evidence reflects shortcomings in the public choice approach).

261. See, e.g., Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q. J. ECON. 371, 384 (1983) (suggesting that "political policies that raise efficiency are more likely to be adopted than policies that lower efficiency").

262. Croley, *supra* note 1, at 5, 59; see also Robert B. Reich, *Public Administration and Public Deliberation: An Interpretative Essay*, 94 YALE L. J. 1617, 1619-20 (1985)

The third theory, public interest, is also more open to a potentially positive regulatory role and process. However, this theory adopts public choice's critical view of interest groups, and holds that only full disclosure of the administrative process to general public scrutiny and monitoring saves an administrative regime from capture by such groups.²⁶³ Where particular processes afford the public this critical scrutiny of regulatory decision making, the theory contends that results tend to reflect the general public interest.²⁶⁴ In contrast, where the process fails to provide such scrutiny and the decision makers operate without public oversight, results tend to benefit well-organized interest groups at the expense of the public.

Each of these theories contains both positive and normative elements, and it is not completely clear to what degree the theories are contradictory, compatible, or complementary. One of the claims of recent scholarship is that the administrative law debate can be advanced by grounding these theories in the details of specific administrative processes.²⁶⁵ It is in this capacity that the analysis of the APA program and its operation may be valuable.

One caveat, however, must be noted. Although all regulation moves through administrative regimes and thus theoretical discussions have wide application, important distinctions exist. Social regulation in areas such as environment, food safety, and occupational safety differ from regulation in taxation and social security. The former represent acts of government intervention into conduct otherwise undertaken by the market. The government justifies its intervention on the grounds of market failure.²⁶⁶ In contrast, redistributive regimes such as taxation and social security, do not redress market failure but instead serve a function entirely separate from the market. Thus, to the extent theoretical discussions focus on normative justifications for the creation of particular administrative regimes, universal answers do not exist. Social regulation and redistributive regimes rely on different foundations.

(explaining that this focus on interest group competition envisioned the public administrator's role as to "accommodate . . . the varying demands . . . of competing groups" and that "'public interest'" was understood as an "aggregation and reconciliation of these claims [and that] the administrator succeeded to the extent that he was able to placate the competing groups"); Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1669, 1723-48 (1975).

263. See Croley, *supra* note 1, at 5; see also Levine & Forrence, *supra* note 258, at 174, 184, 192-93 (outlining theory that the degree of "slack" (i.e. lack of public scrutiny) a regulator experiences on a given issue impacts the degree to which the regulator will pursue interest group or ideological results instead of general interest results).

264. See generally Croley, *supra* note 1, at 68.

265. *Id.* at 7.

266. See *supra* note 259.

However, to the extent the administrative theories seek to probe what happens in a regulatory regime, both redistributive and social regulation regimes share some common analyses. Understanding the various ways in which power, structure and process interact in a regulatory setting has universal salience. The similar problems experienced implementing environmental and transfer pricing regulation attest to the potential value of shared learning among regimes that differ in other respects.

In considering whether the APA program in particular can provide any support for one of these theories, it is important to consider all three facets of the APA: namely its creation, its modification, and its operation. The creation of the APA program provides little direct support for any of the three theories. The program was initiated at the prompting of the Service itself in response to what it, and many taxpayers, perceived to be serious problems with the operation of the transfer pricing tax rules. However, even more significant than the fact that the Service initiated the program is the fact that the general response of the intended audience—multinational corporations with significant cross border related party transactions—was not warm. It seems unlikely, therefore, that the program was the result of pressure from a narrow interest group of taxpayers as would be predicted by the public choice theory or from a competition among well-organized interest groups as predicted by the neopluralist theory. Certainly, of course, a few taxpayers were interested in APAs. Shortly after the program was formally introduced the Service announced the first completed APAs, which obviously had been underway prior to the formal announcement. Nonetheless, the overall factual picture of the development of the program does not really support a strong claim that one or more narrow interest groups were the primary actors behind the program. Nor is it clear that its creation reflects the triumph of narrow interests over the general public interest. To the extent that a significant motivation for and potential outcome of the program is the alleviation of administrative burden and the improvement of transfer pricing regulations, the benefit is both a specific one for taxpayers facing transfer pricing issues, and a general one for the public in terms of improved tax administration. Of course the degree of disclosure poses some difficult questions that are considered below in evaluating the APA program's operation.

The creation of the program also fails to provide much evidence that the public interest theory was at work here. The APA program was presented in 1991 as a complete, new program. The general public, even through their congressional representatives, had little oversight of the creation process. Despite the fact that the creation of the APA program

lends little direct support to any particular administrative theory, the subsequent modifications present a slightly different picture.

Two notable changes to the program, the restructuring of the role of foreign governments²⁶⁷ and the introduction of a special APA route for small businesses, were both responses to concerns raised by particular "interest groups." In the case of foreign countries' place in the APA process, the Service found that under the 1991 structure, other nations considered their role in the development of the taxpayer's transfer pricing treatment inadequate.²⁶⁸ Given the critical position of foreign nations in preventing the double taxation that the APA was designed in part to eliminate, they served as a significant "interest group" whose needs had to be accommodated.²⁶⁹ Thus, it is not surprising that the Service reevaluated the foreign countries' role and ultimately revised the program—to the initial dissatisfaction of at least some taxpayers.²⁷⁰

On one level this modification seems to support an administrative theory along the lines of public choice, with the foreign countries emerging as the successful interest group. This picture, however, is complicated by the fact that this "interest group" is another foreign government acting in essentially the same regulatory capacity as the Service. Considered in that light, a characterization of the foreign government as an "interest group" may be misleading. Although there is no one valid interpretation of public choice theory and its view of interest group competition, the simple case presumably envisions a single government/regulatory body responding to various interest groups formed from the general public, all portions of which are bound by the final decisions stemming from the regulatory process. A foreign government with an equal claim to the same regulatory authority does not operate as a traditional interest group in that context. It does not even have the same relationship as a state level agency in a federal system, or even as another federal agency with an interest in the topic. The tax bodies of other countries are in precisely the same position vis a vis transfer pricing as the Service without any ultimate supranational authority. Moreover, transfer pricing decisions of one country directly impact those of another. The result is the intersection of two independent, although connected, regimes. This relationship cannot be examined exclusively within the context of traditional administrative law

267. See *supra* note 104 and accompanying text.

268. *Id.*

269. The Service's preference for bilateral and multilateral APAs over unilateral APAs, (the former typically offer much more predictability and dispute reduction) is easy to understand. However, it necessarily depends on the cooperation of foreign sovereigns.

270. See *supra* note 86.

concepts. Thus, it may make sense to seriously explore the applicability of international relations theory in evaluating that dynamic. What this example does clarify is that administrative law theories, as difficult as they may be to work with in the domestic context, become more complicated with the inclusion of other governments and their parallel regulatory bodies.²⁷¹

Regarding the other significant modification of the APA program, the creation of a small business track, more than one administrative theory seems relevant although none exclusively so. Viewed as a response to demands from smaller international businesses that the APA program be more accessible to smaller taxpayers, the modification may seem an example of public choice theory (or perhaps neopluralist theory). However, it may not be accurate to consider the creation of the smaller business track to be a concession counter to the general public's interest, nor a change taking place outside the public's attention. Thinking in terms of the public interest theory, it is relevant to note that the Service continually publicized its desire and intent to provide an APA format more suitable for smaller businesses. The prospect of this particular modification seemed to raise no general or interest group specific complaint. Rather, it aligned with a fundamental view that if the APA program exists it should be accessible to the full range of relevant taxpayers.

As noted earlier, this section seeks to measure the three general theories of administration and the regulatory state against the experience of the APA program. The first part of this assessment looked at the creation and modification of the program. This second part now reviews the implementation of the program. It is here that fuller clues exist regarding the aptness of various administrative theories in this context. The individualized nature of the APA process and the refusal to consider disclosure until the Service's short-lived announcement suggest that "good" would fail to result from the clash of interest groups because each party who wants to "play" (i.e., negotiate transfer pricing individually with the Service) could engage the government in relative privacy.²⁷² The APA regime makes it difficult, if not impossible, for competing groups or the public to monitor or challenge the resulting tax treatments and policies. Thus, if one takes the baseline behavior shared

271. As is often the case for international issues, parallels to state-federal relations in the United States may prove useful, although the absence of the federal structure internationally means countries' relationships to each other do not completely match state-state and state-federal relations in the United States.

272. Unless the foreign government is counted as a competing interest group, which as suggested above, does not aptly describe the role of other governments in the process.

by the neopluralist and public choice views, one might see the handiwork of public choice and its dismal portent, as the eventual prospect of the APA program.

Certain additional observations about the program, however, might nullify this prediction. The degree of resistance to the APA program exhibited by taxpayers suggests that the corporations did not see themselves as predominantly in a position vis-a-vis the Service to compete or pressure for desired tax treatment. Rather, the paramount taxpayer concerns regarding the provision of detailed information to the Service suggest they saw a different relationship. Of course, some taxpayers did go forward with the process, but those decisions seem sufficiently explained by their particular risks of possible bad audits, current bad audits, or high transaction costs. Even assuming this description of taxpayers' understanding of their relationship with the government prior to starting the APA process is accurate, it still remains plausible that once engaged in the process, the factors of individualization and nondisclosure (until now) enabled participants to pursue their agendas in a public choice-like arena. However, the more unique aspect of the APA regulatory environment as compared to typical "domestic" settings may impede a participating taxpayer's ability to fully achieve a public choice type result. The fact that most APAs are bilateral or multilateral (and the fact that there is some element of zero-sum to the amount of tax collected by all countries regarding a cross border related party transaction) suggests that the taxpayer cannot easily pursue an aggressively self-interested path under the public choice theory because fiscal "sacrifices" by the Service could be eagerly scooped up by the other country or countries. This is not to suggest that some version of public choice behavior cannot occur, just that the taxpayer's maneuvering is more complicated in this multi-jurisdictional administrative setting.

Moreover, even if a public choice type result might be foreseeable under the program as it has existed thus far, public interest theory may provide a more accurate view of the dynamic under APA processes for the future. As noted above, the public interest view refines the other two theories by asserting the ameliorative effect of public monitoring. The theory anticipates that despite the activity of interest groups, when the public can monitor behavior it ensures that general good and not simply individual good is achieved. To the extent this monitoring mitigates the harsh view of the administrative process, its unavailability at all in the APA context until now, has meant that the level of public information on outcomes was limited (even if "public" here is taken to be the larger class of active multinational corporations, policy makers, academics, and

tax media) and may have provided opportunity for taxpayers to at least vie for a public choice result behind closed doors. However, the recent legislation barring disclosure but requiring annual reporting means there will be more information available than there has been, but perhaps less than it could be.

As discussed earlier in Part IV, the real operational impact of the new reporting requirement turns on what is revealed. A very generalized report will leave nonparticipants still unclear on precisely what rules are being applied. Conversely, a rich report increases the awareness in the tax community of the standards to which transactions will be held but also risks the publication of information that might be identifiable by country or industry. This direction could push the APA process towards neopluralist or public interest models as parties other than the relevant taxpayer become part of the process. Although the "public's" interest in APA results may never be high, if the broader tax community including nonparticipating multinationals, other taxpayers, tax media, policy makers, and academics are able to examine the direction of the APA program, they may effectively monitor APA treatments, thus achieving some of the goals of the public interest model.²⁷³

The first cut observations here support the idea that the particularized administrative setting plays a significant role in what theoretical view is most descriptive. Agencies and administrative processes are not monolithic; moreover the typical interactions among an agency, interest groups, and the public may vary—even within a given agency and process. It is possible that different issues and facets operate more or less under different theories. Perhaps the most interesting observation from the APA program case study is that the move from a domestic administrative and regulatory setting to an international one involving multiple jurisdictions complicates the interpretation of the various parties' actions in very specific ways. The position of the foreign governments in the APA process makes it difficult to classify behavior and determine who is an interest group and who is the bureaucracy for purposes of administrative theories.

273. This, in effect, provides an opportunity for the Neopluralism theory to apply, if other taxpayers can be considered "other" interest groups. However, the *post hoc* nature of the disclosure, and the indirect benefit to such groups, counsels against placing too much weight on such an analogy. It may be better to view other taxpayers, comprising the taxed community in general as well as others aware of the Service's actions and the impact on the public fisc, as providing the oversight needed for public interest theory to function properly.

B. Functional Aspect of APA Program Design Choices

While it is possible to sift through the genesis and results of the APA process for evidence of one or another underlying causal theory governing administrative interactions, an alternative approach in administrative law eschews the search for an overarching principle and would instead examine the APA experience for more practical information on administrative design. Instead of accepting the premises of private party-government interactions and the dominant role of interest group behavior and working from there, this alternative operates under the view that new frameworks and formats of administrative and regulatory action can produce different interactions. Thus, a substantial emphasis is placed on what might be done differently if agencies have an opportunity to consider creative, context-specific approaches. The starting point for this functional view is the possible relationship that an administrative regime may construct between and among the government, interest groups, and public. Change in this multifaceted relationship is sought through revised regulatory processes that encourage participation, problem solving, and agency flexibility in ways that permit agencies to establish systems best suited to the regulatory problem at hand.

One version of this approach is "collaborative governance."²⁷⁴ This basic model has generated a variety of regulatory devices such as negotiated rulemaking and special EPA permitting practices.²⁷⁵ Very briefly summarized, the suggestion is that more joint, collaborative rulemaking processes may be advantageous because they (1) may produce novel and better solutions if the less adversarial atmosphere allows more information to be generated and debated, and (2) the mutual participation in a consensus building format may improve relations which in and of itself is valuable but also feeds back into other stages and aspects of the administrative process.²⁷⁶

Another version is civic republicanism. Positing that regulatory decisions reflect broad judgments about how competing regulatory values should be balanced,²⁷⁷ the civic republican theory argues that the process of regulation serves as the occasion for collective discussion and deliberation about both the means and ends of the regulation at issue.²⁷⁸ Such deliberation, properly structured, provides a further forum for

274. See, Freeman, *supra* note 1.

275. See *supra* text accompanying notes 252–254.

276. See Freeman, *supra* note 1, at 23–24.

277. See, e.g., Cass R. Sunstein, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE 12 (1990); Croley, *supra* note 1, at 57–62.

278. See Croley, *supra* note 1, at 5.

refining the requirements of the general public's interest. Reliance on deliberation by expert administrators replaces interest group competition as the key to legitimate rulemaking.²⁷⁹ Still other paradigms for rethinking administrative law have emerged in the environmental arena including "reflexive regulation," "cooperative implementation," and "interactive compliance."²⁸⁰ Regardless of their precise scope or formulation, these theories share a common focus on the value of cooperation in the regulatory process and the flexibility necessary to achieve it.

To really facilitate successful collaborative governance of some type, an administrative system requires a certain flexibility and discretion to consider new structures and options and retain the possibility of rejecting plans that fail. The government agency functions as an active administrative player in terms of exploring, testing, and developing administrative options. The agency draws parties in by identifying how the process can benefit them, through "cost savings, reduced litigation, or improved relationships."²⁸¹

This ground level approach to administrative and regulatory theory, with its rousing call for creative administrative processes still recognizes the core concerns of accountability and measurement of success. A collaborative approach does not eschew mechanisms for accountability. Instead, it folds that necessary feature into the heart of the theory. Accountability becomes one of the administrative features for which creativity is possible and a range of options and structures must be investigated.

Measuring the success of a new design is a perennial problem both in terms of deciding what factors are relevant and how they can be measured in a useful way. To adequately assess an approach that emphasizes creative, contextual regulatory processes, case studies remain central. In this capacity the analysis of the APA program again may be helpful. The connection between the APA program and a more collaborative regulatory model is strong. The goals thought to be achieved by changing the system and presumably the parties' relationships are very much the ones underlying the APA program.²⁸² As discussed in greater detail in Parts I and III, the transfer pricing system appeared in crisis because among other things, it was adversarial, was

279. See Freeman, *supra* note 1, at 20.

280. Breger, *supra* note 1, at 325 (briefly reviewing the new frameworks).

281. Freeman, *supra* note 1, at 31-32.

282. See, e.g., *supra* text accompanying notes 135-146. The APA program's change in the taxpayer-Service interaction was the result of flexibility to restructure and reorganize relationships in the administrative process.

unsuited to the highly factual content, elicited limited information, and failed to include all of the critical parties in the initial steps. The Service designed the APA program with the expectation that it could provide an improved forum for examining transfer pricing problems, designing appropriate tax treatments, and resolving disagreements. The inclusion of the foreign governments in the process was a novel but ultimately crucial choice in creating a process with a plausible chance for success. Accountability has proven the most contentious issue but is itself in the process of being modified, though the sufficiency of the solution awaits judgment.

The specific criticisms targeted at the APA program reveal the direct tension between a "collaborative" model and the traditional rulemaking/adjudication framework. In Parts III and IV, the tension was captured in the description of the APA program as a hybrid by virtue of its departure from a clear division between rulemaking and adjudication. The same clash exists at the theory level because the division of tasks and functions into the two categories conflicts with a call for flexibility and creativity that could muddle such delineated roles. However, the blurring of roles need not subvert an administrative process. For example, inclusion of a range of personnel at the one and only stage of the APA program does not inappropriately mix administrative roles. Instead, it encourages broader participation and creates an atmosphere of joint responsibility for solving problems. A collaborative approach may, through its departure from traditional patterns of interaction, solve problems without seriously undermining the integrity of the administrative process. The real value of some version of collaborative administrative theory is that it not only permits agencies the opportunity to design innovative process but in fact it places intelligent creativity at the forefront of regulatory policy. The decision to value the qualities of creativity, flexibility, and innovative structure by supporting a different vision of administrative relations may be most appropriate where certain conditions exist. In particular, the existence of features such as high information costs, fact intensive issues, large stakes, very interdependent decisions, and multiple regulating entities, may outweigh the possible risks. Certainly uncontrolled flexibility and administrative discretion are not a plausible solution to the current ills of the regulatory state. What can be stated with assurance is that refusal to seriously consider reform alternatives and failure to allow some experimentation guarantees little improvement will be made.

Although the APA program cannot unequivocally demonstrate the success and correctness of an approach that emphasizes agency flexibility, creativity and collaboration in rulemaking, it offers a useful

example of how such changes can be made to an administrative process. Moreover, even if specific collaborative governance routes prove problematic, and more attention to interest group behavior is needed, some aspects of the program such as creative rulemaking nonetheless remain a valuable alternative for confronting regulatory problems.

CONCLUSION

SPECIFIC PROJECT

Returning to the primary goal of this paper—evaluating a recent procedural innovation in terms of its impact on both participants and nonparticipants—certain conclusions can be drawn. The examination of the APA program reveals that this new hybrid, which was created in response to burdens facing the tax system from transfer pricing, has been reasonably successful in improving the administrability of transfer pricing for participants, although it has introduced some problems for nonparticipants. A continuing research agenda would next consider the broader institutional issues raised by the APA program including the allocation of government resources (time, money, expertise), change in taxpayer resources devoted to transfer pricing issues, and government revenues from the transactions under the new procedure.²⁸³

If the program is to continue to operate in its current format, a serious question emerges as to whether the transfer pricing “solution” has come at too high a cost. The answer to the question turns on what government resources are expended for how many taxpayers and issues, and how easily the results are translated into “cheaper” assistance for multinational taxpayers generally. On the one hand, it is possible that annual APA program reports may sufficiently offset the allocation of resources to the program. On the other, it may be that (1) redacted APAs are a necessary minimum, or (2) translation of the many fact specific aspects of transfer pricing into formal guidance is too difficult. However, even if the more pessimistic picture prevails in the long term, the operation of the program in the interim period may nonetheless have been useful. The program has drawn other countries into a process for examining tax issues and cases which is different from those in place to date. If the APA program did not specifically continue as part of the administrative structure, its legacy of innovation and more intense, multi-governmental involvement in the regulatory/administrative process may continue in new forms.

283. See, e.g., Coglianese, *supra* note 181.

Any analysis of innovations like the APA process will be informed by the positive and normative theories of administrative law. The goals for the tax system, the questions raised, and the interpretations drawn regarding the new procedure reflect one's underlying administrative law perspective. Nonetheless, the influence is not one way. Given the current debate over administrative law theories outlined at the beginning of the paper, detailed information about the dynamics and operation of procedures like the APA program should help expand analysis and understanding of the competing and overlapping theories. Case studies both influence and are influenced by these trends in legal theory.

BROADER ADMINISTRATIVE CONCLUSIONS

Regardless of the particular theory advocated, two aspects of the APA program stand out as significant for general administrative reform efforts: (1) government discretion/flexibility, and (2) role of multi jurisdictional interaction. The ability of the tax system to design and implement this responsive program required two kinds of government discretion. First, it required the flexibility to create a hybrid procedure tailored to the problems experienced. Second, it required flexibility within the innovation—that is, an innovation whose actual function and operation relied on a degree of government discretion and flexibility. This is not to suggest that unfettered discretion should be the new mantra.²⁸⁴ However, there is an advantage to discretion, especially where it is hard to continuously modify the rules to clearly capture cases and catch abuse. Such authority for the Service could be effective in cabining taxpayer abuse and simplifying the audit process by reducing formal bases for conflict. Even without pursuing such an extreme direction, seeing the APA program in the context of a debate over the nature and degree of discretion permitted in the tax system can lead us to view the program as a way to grant discretion in a limited setting. Moreover, discretion implemented in a context like the APA program poses less affirmative danger to taxpayers because they can walk away from the forum.

The other special feature of the program—the role of cross border interaction—may be most critical for the wider administrative law community. Although international tax policy is in part based on a

284. Despite the current barrage of criticism regarding the Service, it is by many standards a fairly well-functioning administrative and collection system, partly for structural reasons like wage withholding that limit fraud potential, and partly because of the emphasis on rules and regulations as opposed to *de facto* broader discretion and negotiation that can be more predominant in other countries.

shared commitment by countries to avoid double taxation—and thus requires specific, focused interactions between governments—many other substantive administrative regimes presumably involve overlapping regulation with other countries. A procedure like the APA program introduces the other government(s) to a tangible regulatory problem in a way that may substantially change the dynamics and results. Even if the future of the APA program is limited in some way, this feature of the program (the role of the foreign governments) already stands as a significant innovation.

Developing structures to link the activities of the various national regulatory authorities is important in the current global regulatory environment, which has extensive multilateral interactions but no supra national authority. Existing international organizations (e.g., the OECD, European Union, PATA) offer one type of forum. However, the APA model's case-by-case prospective analysis requires focused attention on a particular problem. Thus, the APA program puts a little more pressure on countries to accomplish results. At the same time, the APA interactions can be more principled substantively and potentially less confrontational than traditional *ex post* competent authority proceedings where focus on the legal issues can be shaded by the existence of a completed transaction and actual tax dollars on the table.

These characteristics of the APA process are positive—countries developing shared procedures which facilitate a clearer understanding of their respective transfer pricing approaches and lead to multilateral efforts to address problems like global trading. Of course, this does not mean that underlying issues become easy; the advantage is creating formats, structures and processes that provide better opportunities for interaction and resolution.

Ultimately, the APA program, its history, function, and controversy provide a valuable context in which to consider the more general questions of administrative flexibility and discretion. The pressure for such flexibility and creativity may be even stronger in the future as regulatory questions commonly involve other countries with whom we need better ways to coordinate regulatory regimes.