Formulary apportionment, as an alternative to the arm's-length standard, could simplify transfer pricing and maximize tax revenue, and would not impede firms' ability to engage in cross-border trade.

Cost Sharing Regulations

The Case for Formulary Apportionment Transfer Pricing

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The cost sharing Temporary Regulations issued in December 2008 (REG-144615-02, TD 9441, December 31, 2008)[1] are overly restrictive and do not achieve Treasury's goal of maximizing tax revenue while still encouraging cost sharing agreements. This article proposes formulary apportionment as an alternative to the arm's-length standard, a method by which Treasury could simplify the current transfer pricing system and maximize tax revenue without impeding firms' ability to engage in cross-border trade.

Section 482—History and Development

Section 482 is currently the IRS's principal weapon against abusive transfer pricing schemes, but it was not originally enacted with international considerations in mind. As initially enacted, the legislative history of Section 482 states that it was designed to combat "the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'."[2] This could be accomplished if one party "controlled" another party, and could manipulate prices. Section 482 was, therefore, enacted to put a "controlled" taxpayer in the same position as an "uncontrolled" taxpayer doing business in the same circumstances.[3] Transfer pricing is the shifting of profits, losses, deductions, or credits within an affiliated group such that the resulting income tax of the group is less overall. The IRS allows transfer pricing so long as it does not represent the shifting of income solely for tax avoidance in a manner that would not have occurred between parties acting at arm's length.[4]

As transfer pricing was used increasingly to take advantage of low-tax or zero-tax haven countries, Section 482 evolved to combat abusive international transfer pricing by shifting income back to the United States, giving the IRS the ability to "create income where none is realized."[5] Yet Section 482 was enacted in a closed economy that never envisioned eroding the U.S. tax base through the use of tax havens and low-tax jurisdictions. This is a major reason for the ineffectiveness of certain aspects of Section 482 in international taxation, since it was founded on concepts that are now outdated and badly in need of reevaluation and reform.[6]

As Regulations were promulgated under Section 482 to counteract transfer pricing, Section 482 was very successful in policing cases that involved tangible property, including goods, since a clear transfer price could be determined for how much an "uncontrolled" party would pay for the goods in the open market, using a variety of methods in the Regulations.[7] The implementation of Section 482 in the transfer pricing of intangibles was more difficult, however, since the valuation of intangibles on transfer was much more subjective and, therefore, harder to value. This is because intangibles, such as the right to use a patent, often are not very valuable in their early phases but can become extremely valuable in their later stages.[8] The primary difficulty in valuation is whether the transfer of an intangible in early-stage development should account for the potential future profits that the intangible may generate once fully developed and marketed. The valuation is further distorted because intangibles often do not have one consistent market price, as goodwill, future profits, and profitability of the intangible are not certain during the early development stages at the time of transfer.[9]

Cost sharing agreements, developed to address the transfer pricing of intangibles, became quite popular in the 1990s and 2000s. Under these agreements, a U.S. multinational would transfer the rights to an intangible to its foreign subsidiary, and the parent and subsidiary would jointly develop and own the rights to the intangible. The transfer to the subsidiary generally was made at an early stage of development when the intangible was worth relatively little, and after it was fully developed, both the parent and the subsidiary would have rights to the use of the intangible, often in differing jurisdictions, so their rights did not overlap.[10]

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The 1968 Regulations were the first to mention cost sharing agreements. They stated that if the parties entered into a bona fide cost sharing agreement to develop intangibles, no Section 482 adjustment would be made provided that the costs were made at arm's length and the cost sharing would be the same as unrelated parties would adopt.[11] The Tax Reform Act of 1986 amended this concept, adding a sentence to Section 482 stating that the pricing of the intangible must be commensurate with the income attributable to the intangible.[12] Basically, under the commensurate-with-income standard, controlled parties could enter into a valid cost sharing arrangement provided that each party bore its fair share of the costs associated with the income likely to be generated from the arrangement.[13] Therefore, a party could not reap more benefits than its total costs expended relating to the development of the intangible. These costs could arise in two ways—as costs paid in consideration for the initial transfer of the intangible in a lump-sum payment ("buy in"), or as costs incurred after the transfer through payment to employees for research and development of the intangible.

Perhaps the most influential study on transfer pricing was Treasury's 1988 "A Study of Intercompany Pricing Under Section 482 of the Code" ("White Paper").[14] The study postulated that additional regulation of cost sharing agreements was needed, suggesting that participants should be assigned exclusive geographic rights for developed intangibles, and that future benefits should be anticipated and accounted for in the initial transfer of the intangible. As originally enacted, the White Paper's revisions would have been unduly harsh, much the same way that Subpart F, as originally envisioned by the Kennedy Administration, was overzealous and would have restricted transactions not meant to be covered by the anti-deferral regime.[15]

Treasury realized this and in 1992 issued Proposed Regulations that provided greater flexibility than the White Paper envisioned.[16] These Regulations required that costs be shared in proportion to benefits, and that if a parent transferred an intangible to a subsidiary, the subsidiary had to pay consideration for the intangible (a "buy-in.").[17] The final Regulations issued in 1995 embodied much of these same principles, including the cost-benefit analysis and buy-in payment requirement, and did not contain some of the more restrictive rules in the White Paper.[18] These Regulations further provided a method for continuing oversight to test if the income actually generated by the intangible was commensurate with the income projected at the time of the transfer. In addition, the Regulations included a safe harbor—there would be no adjustment under Section 482 if the actual income generated by the intangible varied less than 20 percentage points from the projected income at the time of the transfer.[19]

Under those Regulations, the consequence of failing the 20% test was that the IRS could adjust the sharing of costs under the agreement so that the benefits were "commensurate with income." This method was still greatly preferred over the default rule, which created a chargeback under Section 367(d) of the income generated by the intangible, back to the

The investor model is flawed at its very core because it was enacted only to take into consideration perceived tax abuses

1 See Baker & McKenzie North America Transfer Pricing Group, "Cost Sharing Arrangements Are Less Attractive Under New Regulations," 20 JOIT 20 (April 2009).

2 S. Rep't No. 70-960, 70th Cong., 1st Sess. (1928). While the legislative history is not entirely clear, the original intended purpose of Section 482 seemed to encompass transactions such as below-market loans between parent and subsidiary corporations, and other transactions that could be entered into solely because the two parties were under common control and, therefore, shared benefits as a group rather than as separate taxpayers. The purpose of Section 482, then, was to put the transaction between the parent and the subsidiary in the same position had the taxpayers not been under common control—the arm's-length standard.

3 Reg. 1.482-1(a)(1).

4 Reg. 1.482-1(b)(1).

5 Reg. 1.482-1(f)(1)(ii). This is the IRS's most potent weapon in the transfer pricing rules, because in large corporations the amount of income that can be readjusted by the Commissioner and the resulting tax liability without income for some corporations can be in the billions of dollars. See McIntyre and McIntyre, "Using NAFTA to Introduce Formulary Apportionment," 6 Tax Notes Int'l 851-856 (April 5, 1993), which estimated that by 2000, the Tax Court's backlog of Section 482 cases could exceed $100 billion in disputed taxes. This is also one of the largest potential areas for additional revenue to be generated by the IRS. See Brauner, "Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes," 28 Va. Tax Rev. 79 (2008).

6 See Graetz, "David R. Tillinghast Lecture: Taxing International Income: Inadequate Principles, Outdated Concept, and Unsatisfactory Policy," 54 Tax L. Rev. 261 (2001).

7 Reg. 1.482-1(c)(2)(i). The five methods in the Regulations are comparable uncontrolled price (CUP), resale price, cost-plus, comparable profits, and profit-split. Reg. 1.482-3(a).

8 For example, during its development, the patent for Viagra did not have much value because there was no use for it in an undeveloped form. After the drug was marketed and sold successfully, the patent in final form became worth considerably more.

9 See Brauner, *supra* note 5.

10 For example, the parent would transfer to the subsidiary the rights for a particular "field of use," e.g., the rights to license the intangible in Europe. The parent would often retain the rest of the rights. Therefore, while the parent and subsidiary both own the rights to the intangible, their rights do not overlap in its worldwide use.

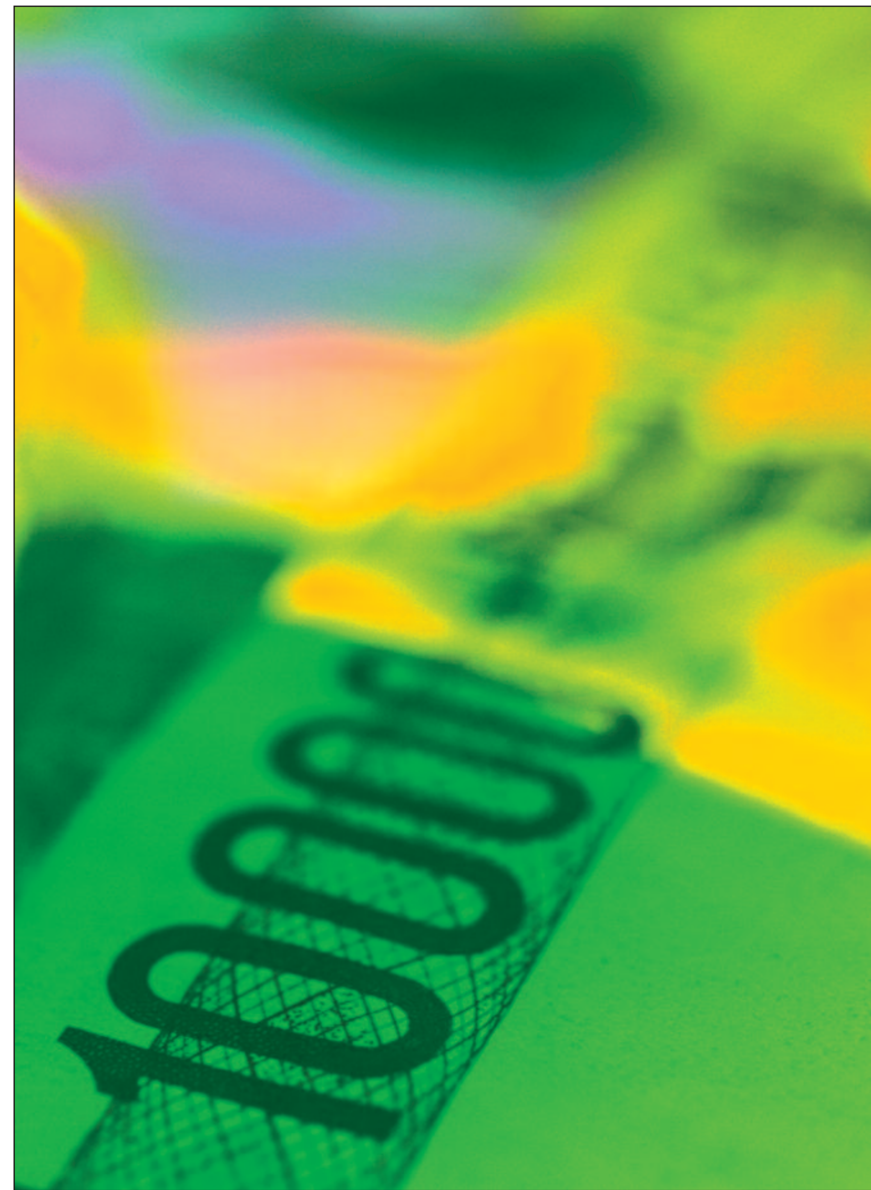
11 Reg. 1.482-2(d)(4) (1968). See Lemein, "Sharing Intangible Property Within a Multinational Group: Facts Versus Theories," PLI Order No. 14322 (2005).

12 Tax Reform Act of 1986, P.L. 99-514, October 22, 1986, section 1231(e)(1).

13 *Id.* The 1986 Act introduced the concept that parties must share in the risks of the cost sharing agreement if they are to reap the rewards of the agreement. This concept is now at the heart of the current transfer pricing Regulations and underlies most of the reallocation of income under Section 482 in current transfer pricing audits.

transferor parent. The default rule occurred whenever a transferor corporation did not pay a buy-in at all.[20] This chargeback of income, or "super royalty," generally imputes an income payment for royalties back to the transferor over the useful life of the intangible.[21]

Cost sharing arrangements, therefore, became the structural vehicle of choice for transferring intangibles abroad for use within an affiliated group in the 1990s, because they avoided the "super-royalty" charge-back by requiring an initial buy-in, and allowed a transfer during early-stage development, and subsequent use by the subsidiary through research and development costs. While not overly restrictive, these Regulations provided a method for IRS monitoring of cost sharing agreements that, for the most part, represented arm's-length prices, and generated a fair result to both the taxpayer and the government during its inception.



Cost Sharing Abuse and the "New" Regulations

In the 1990s, stock-based compensation became a common form of remuneration for CEOs in many large, publicly traded corporations. The grant of stock options was particularly popular as compensation not only for executives, but also for employees, as a relatively inexpensive way to entice them to leave their current employment for a new company with greater financial rewards if the new company was successful. Companies with small liquid investments to pay employees could issue stock options at relatively small or no cost, and acquire human capital that would traditionally require high, cash-based compensation. Thus, the granting of stock options or equity compensation flourished in the 1990s as an alternative to cash-based compensation.

Companies soon discovered that, for tax purposes, stock options were not a "cost" that needed to be factored into a cost sharing agreement. This could allow parent companies to incur fewer "costs" for purposes of the cost sharing agreement, which normally would have been cash-based compensation. This had the effect of shifting costs to the foreign subsidiary. Since benefits or license rights had to be equal to costs incurred in the cost sharing agreement, companies could grant more license rights to the foreign subsidiary without the subsidiary having to pay the parent for these rights (the buy-in or commensurate-with-income standards).

This presented unique challenges to the IRS. Statutorily, the taxpayer had the tax law on its side in valuing the "cost" of a stock option for purposes of a cost sharing agreement. If the salary was paid in cash, this amount was clearly includable in the employee's income under Section 83(a) and deductible to the corporation under Section 83(h).[22] The IRS, therefore, had no problem articulating that payment of a salary to an employee was a "cost" within the meaning of a cost sharing arrangement. However, the transfer of statutory stock options under Section 83 generally did not constitute a transfer of property subject to Reg. 1.83-3(a)(2). Accordingly, these options would not be included as a "cost" for purposes of a cost sharing agreement.[23] As a result, several corporations began to issue stock options and not include them in costs because, as noted, they had the tax law on their side. The following example illustrates the problem.

Example. Under a cost sharing arrangement the participants' costs must equal their reasonably anticipated share of benefits.[24] If a domestic parent and foreign subsidiary proposed to share the benefits of an intangible jointly or 50% each, they must bear an equal amount of the costs. If the costs were incurred in cash, the domestic parent might incur 75% of the costs due to cash-based salaries, as well as research and development costs, while the subsidiary would incur only 25% of the costs. In this instance, the IRS could deem a payment from the subsidiary back to the parent to reflect a cost that the subsidiary did not incur in relation to its share of reasonably anticipated benefits. This would result in an increase in tax liability to the transferor corporation when the IRS shifts the income payment back to the parent.[25]

Instead, if the domestic parent pays the foreign subsidiary's employees in stock options, this cost does not need to be included in the parent's tax return as a deduction under Section 83. Companies, therefore, took the position that since they statutorily did not receive a deduction for it, it was not a "cost" for purposes of a cost sharing agreement.[26] Therefore, in the above example, the parent's costs, as a result of not including the cost of the stock options, would drop from 75% to 50%, and there would be no reallocation of income back to the parent in payment of the intangible that the subsidiary received as a result of issuing the stock options instead of cash salaries.

In *Xilinx, Inc.*, 125 TC 37 (2005), the IRS challenged this issue of stock-based compensation in cost sharing agreements.[27] The IRS's position was that, although there was statutory authority for not including the stock options as a deduction in the year of grant, the cost of the stock options should still be included to the parent under Section 83. The Tax Court disagreed and held for the taxpayer.[28] Treasury, realizing the importance of this issue to the federal government, issued Proposed Regulations in 2002 during the pendency of *Xilinx*, which specifically included stock options as a cost in the cost sharing agreement. After *Xilinx* was decided in favor of the taxpayer, Treasury repealed the 2002 Regulations and issued a new set of Proposed Regulations in 2005 that addressed not only stock options, but several other abuses that Treasury thought needed fixing regarding cost sharing agreements in general.[29] The 2005 Proposed Regulations, which are the foundation for the 2009 Temporary Regulations, significantly changed all prior sets of cost sharing Regulations, were extremely restrictive, and received substantial criticism when originally issued.[30] The main reason was that they actually diverged from the arm's-length standard.

The biggest problem in implementing formulary apportionment is that all countries must agree on the same formula

The 2005 Proposed Regulations dealt with two primary areas: (1) the initial buy-in payment and (2) the new "investor" model. They required a foreign subsidiary to pay a domestic parent a buy-in equal to both the value of the intangible on the date of transfer, and all future profits that the intangible was expected to generate. The IRS referred to the combination of these two factors as a preliminary or contemporaneous transaction (PCT).[31] These new factors effectively required the parties to determine how much expected profits the intangible would generate in the future, and factor this into the buy-in payment. The PCT standard, by its very nature, was not an arm's-length standard since uncontrolled parties would never enter into such transactions in a free-market economy. The PCT standard effectively made the price that subsidiaries had to pay for an intangible extremely high for large multinationals. As a result, corporations might not enter into new cost sharing agreements at all because of the prohibitive cost.

The 2005 Proposed Regulations also instituted a new "investor model" for valuing a PCT. Under this model, parties must value their *(Continued on page 59)*

14 Notice 88-123, 1988-2 CB 458.

15 Gustafson, Peroni, and Pugh, *Taxation of International Business Transactions* (3rd ed., Thomson Reuters/West (2005).

16 See Levey, O'Haver, and Clancy, "Practical Problems Remain Under 482 Prop. Regs. (Parts I and II), 2 JOIT 325 (March/April 1992) and 3 JOIT 5 (May/June 1992).

17 McDermott, Dominianni, Cohen, Hudspeth, Stephen, Nee, and Schwartz-Leeper, *Transfer Pricing Under US Law* (IBC Financial Publishing, 1995).

18 TD 8632, 60 Fed. Reg. 65,553 (December 20, 1995). See Lemein, *supra* note 11.

19 Reg. 1.482-7(f)(3)(iv)(B) (1996).

20 Section 367(d); Temp. Reg. 1.367(d)-1T(c).

21 See note 15, *supra*.

22 Section 83 deals with the tax treatment of the transfer of property in connection with the performance of services. It is the primary Code section on compensation of employees for services rendered, and includes the tax treatment of stock-based compensation.

23 Reg. 1.83-3(a)(2). However, for non-qualified stock options, under Reg. 1.83-7, these options are generally taxed only if they have a readily ascertainable fair market value. Under the prevailing accounting and tax treatment prior to the issuance of the new cost sharing Regulations, non-qualified stock options did not have a readily ascertainable fair market value on grant, so they were not a "cost" for purposes of determining costs under qualifying cost sharing arrangements.

24 Reg. 1.482-7(a)(2).

25 *Id.*; Temp. Reg. 1.482-7T(b)(1)(iv), Ex. 3 (2009).

26 See Laurey, "Untangling the Stock Option Cost Sharing Loophole," 55 Tax Law. 761 (2002), cited in Bittker and Lokken, *Fundamentals of International Taxation* (Thomson Reuters/WG&L, 2004/2005).

27 See Levey and Arthur, "Cost Sharing Developments in the U.S.—The Arm's-Length Standard after *Xilinx* and *VERITAS*," 21 JOIT 20 (September 2010); "Ninth Circuit Affirms Tax Court in *Xilinx* on Stock Options and Cost-Sharing," 21 JOIT 5 (June 2010).

28 The IRS argued that that stock options should be included as a cost, and that costs specifically included stock options. The taxpayer, citing the arm's-length and comparable uncontrolled transaction transfer pricing standards, presented significant evidence that uncontrolled taxpayers would not share the costs of the stock options. The Tax Court, following the arm's-length standard, agreed that uncontrolled parties would not share this cost, and held for the taxpayer.

29 See Kirschenbaum, Lemein, Levey, Litsky, McClellan, and Rahim, "Proposed Cost Sharing Regulations Introduce 'New' Standards," 16 JOIT 14 (December 2005).

30 See Lemein, *supra* note 11.

31 Mandolfo, "The IRS's Cost-Sharing Proposals in the Worldwide Tax System: Why Congress Should Avoid Anti-Competitive Transfer Pricing Regulations and Embrace a Territorial Tax," 12 Fordham J. Corp. & Fin. L. 371 (2007).

(*Continued from page 33*) respective costs based on what an investor would invest in the intangible, and what a transferor corporation would likely contribute, based on the risks and returns.[32] Under these terms, the only time that a corporation would enter into a cost sharing agreement is if the profits under the agreement would exceed profits generated if the corporation had developed the intangible on its own.[33] Since parties often enter into cost sharing agreements for other, non-profit driven reasons, such as access to foreign markets, the investor model is flawed at its very core because it was enacted only to take into consideration perceived tax abuses.

The 2009 Temporary Regulations[34] incorporate much of the 2005 Proposed Regulations. They retain the "investor model," which is the primary vehicle that will discourage companies from entering into cost sharing agreements, despite somewhat more flexibility regarding geographical limitations on the use of the intangible.[35] The Regulations also specifically include stock options as a cost in a cost sharing agreement, a factor that was included in the 2002 and 2005 Regulations as well.

The primary problem with the new Regulations is that while Treasury's intention was to close the loophole in the old Regulations, the new Regulations are so restrictive and overzealous in their attempt to fix the problem that many companies will not enter into cost sharing agreements in the first instance.[36] As a result, U.S. multinationals are at a competitive disadvantage compared with other countries, which will result in less overall U.S. revenue and subsequently less capital to tax. These Regulations, therefore, fail to achieve their purpose of generating more revenue for the U.S. Treasury.

An Alternate Formulary Apportionment Regime for Taxing Cost Sharing Agreements

Treasury's new cost sharing Regulations clearly demonstrate that the current transfer pricing rules and Regulations require additional scrutiny to determine their effectiveness in the long run. The Temporary Regulations fail because they are based on the antiquated arm's-length standard that was created before transnational business was envisioned on a large scale. The arm's-length standard evolved over time with international trade, but with each revision, became overly complicated and hard to implement. The new cost sharing Regulations illustrate that the arm's-length standard has ultimately failed; Treasury's solution to the evolution of transfer pricing has resulted in over-regulation that is not achieving its purpose.

A possible solution to this problem is to switch from the outdated arm's-length method to a formulary apportionment system of taxing worldwide profits. Formulary apportionment taxes corporations on their worldwide income based on a "formula" that allocates income to a particular jurisdiction using a measuring device, such as gross receipts. This system is often referred to as a "unitary" approach because it treats all members of an affiliated group as one large corporation for purposes of determining the allocation of income among countries.[37] The formula for income apportionment is frequently based on a weighted percentage of total sales, payroll, and property within the jurisdiction.[38] The goal is to achieve the same result as the arm's-length standard, as both methods attempt to allocate the correct amount of income to a particular jurisdiction and prevent double taxation and price manipulation. The core difference is that formulary apportionment is simpler and less manipulable than the arm's-length standard.

In contrast to the "unitary" system of formulary apportionment, the current U.S. system is a "separate accounting" system[39] under which each corporation of a multinational enterprise is treated as a separate entity for accounting purposes. Hence, subsidiaries organized in foreign jurisdictions file tax returns separate from their U.S. parent, rather than the parent and all of the subsidiaries filing a single worldwide consolidated return.

The fundamental flaw in the current treatment of the arm's-length standard for transfer pricing purposes is that corporate decisions are not made based on a separate-company basis, but rather on an intercompany basis. This results in transfer pricing audit results that corporate executives refer to as "arbitrary" and inconsistent with the reality of the corporate structure.[40] Moreover, taxpayers often manipulate transfer prices and use their method as an "opening bid" in litigation proceedings, where the burden is on the IRS to prove that the taxpayer's method was inconsistent with the arm's-length standard. This results in inefficiency, underreporting, and litigation to determine the correct price.

Formulary apportionment provides a better alternative because the results would not depend on the organization of the corporate group. In effect, the exis-

32 *Id.*

33 Benshalom, "Sourcing the 'Unsourceable': The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions," 26 Va. Tax Rev. 631 (2007).

34 TD 9441, December 31, 2008; 74 Fed. Reg. 340 (January 5, 2009). See Baker & McKenzie North America Transfer Pricing Group, "Cost Sharing Arrangements Are Less Attractive Under New Regulations," 20 JOIT 24 (April 2009).

35 Nadal, "New Regs' Chilling Effect on Cost-Sharing Agreements to Continue, Practitioner Says," 2009 TNT 3-4 (January 7, 2009).

36 See note 31, *supra.*

37 See McIntyre, *supra* note 5.

38 *Id.*

39 Clausing and Avi-Yonah, "Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment," in *Path to Prosperity: Hamilton Project Ideas on Income Security, Education, and Taxes* (Brookings Institution Press, 2008).

40 See McIntyre, *supra* note 5.

41 McIntyre, "Design of a National Formulary Apportionment Tax System," 1991 NTA-TIA 84th Proceedings 118-124 (1992).

42 Report to Senator Byron L. Dorgan (D-ND), "Tax Policy and Administration—California Taxes on Multinational Corporations and Related Federal Issues," GAO/GGD 95-171 (1995).

43 Barclays Bank, PLC v. Franchise Tax Board of California, 512 U.S. 298 (1994). "The 'unitary business/formula apportionment' method calculates the local tax base by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction."

44 *Id.*

45 See note 39, *supra.*

46 *Id.*; see McIntyre, *supra* note 5.

tence of separate subsidiaries in foreign jurisdictions would be ignored. Under this method, the taxable income of a group of corporations is aggregated together as a "unitary" enterprise, then the aggregate taxable income of the group is apportioned to the various jurisdictions based on an internationally accepted formula using a weighted average.[41]

California has adopted a formulary apportionment system to tax multinational corporations on domestic and international income, despite the lack of formulary apportionment adoption at a federal level.[42] Under its current regime, California aggregates a multinational corporation's worldwide income from all of its domestic and international subsidiaries, and apportions some of that income to the state based on a formula—the corporation's property, payroll, and sales within California compared with the total amount located within and outside the United States as a whole.[43]

In *Barclays* Bank,[44] a U.K. corporation engaged in banking did substantial business in California. Based on the state's formulary apportionment system, the Franchise Tax Board of California assessed state tax on Barclays Bank. Barclays challenged the constitutionality of this system, arguing that the apportionment system was arbitrary and violated due process. The U.S. Supreme Court acknowledged the shortcomings of the federal system's arm's-length standard and upheld California's use, and the constitutionality, of the unitary/formulary apportionment system at the state level, finding that California's "reasonable approximations" of the income earned in California did not violate due process.

As a practical matter, however, formulary apportionment has some problems that must be overcome before it can be implemented at the federal level. The biggest problem is that all countries must agree on the same formula.[45] If this does not happen, income earned by multinationals may be subject to double taxation, as Barclays argued to the Franchise Tax Board of California. While international implementation of a single formula is superior from a tax policy perspective, actual implementation requires cooperation from all governments around the world, which is unlikely to happen over a short period. Scholars have suggested that formulary apportionment first be implemented in smaller, cooperative regions, such as the European Union or the NAFTA contracting states, as a preliminary step towards later global adoption.[46] While there are many barriers to adopting a worldwide standard for formulary apportionment, this will probably be the best way to implement global formulary apportionment in the future.

A second problem deals with defining what is a "unit" for purposes of a unitary business, and whether this should encompass branches as well as subsidiaries. This problem carries the same global cooperation difficulties as adopting a formula among all countries around the world, and cannot be overcome in a short period.

Formulary apportionment has been criticized as arbitrary and inferior to the arm's-length method. While this argument may have been true in the earlier years of the arm's-length standard, it is no longer true. The implementation of overly complicated and unduly restrictive transfer pricing methods, such as in the new cost sharing Regulations, highlight the shortcomings of the arm's-length method as it has developed in the 21st century.

Conclusion

By specifically mentioning cost sharing agreements in the 1968 Regulations, Treasury envisioned cost sharing being implemented in transnational business, provided that such agreements represented arm's-length prices. In contrast, the current cost sharing Regulations are so burdensome from a regulatory perspective that many multinationals will strongly consider using other strategies to develop and license intellectual property in the future beyond entering into a cost sharing agreement. Thus, Treasury's aim of allowing cost sharing arrangements, provided that they truly represent arm's-length prices, is not being achieved.

Formulary apportionment, despite the problems that come with switching to a new system, is simpler and easier to implement than the arm's-length method under cost sharing agreements. Further, such a system prevents manipulation by apportioning income based on an objective formula, as opposed to manipulable transfer prices. It also encourages international trade by providing a clear and neutral regime that will not promote uncertainty or litigation.

For these reasons, implementation of a formulary apportionment transfer pricing regime would be more effective and simpler than the current system, provided that the obstacles discussed above are overcome. Treasury should seriously consider switching to a formulary apportionment regime for transfer pricing on a federal level, because it would maximize revenue for the government by encouraging transnational business. Switching to a formulary apportionment regime would also better achieve Treasury's current goal of preventing taxpayer abuse, while still preserving its initial vision of allowing cost sharing agreements for the development of intangibles. ●