

The MNE, as a result, can be expected to weigh the up-front costs of preparing and going through an APA against the probability of an audit and possible subsequent court case sometime in the future and the potential costs associated with that audit (information, legal costs, possible court time if the case goes to tax court). The choice will also be influenced by the fact that some of the information-gathering costs would be borne by the taxing authority in the latter route, whereas both parties share in the savings on court costs. Thus the relative size and distribution of the expected court costs must be compared with the administrative and compliance costs.

Once the APA has been approved, since the IRS is interested in raising tax revenue, the possibility also exists that the APA will be revoked or revised if the critical assumptions change so as to raise the taxpayer's profits. For example, in the case of 'crown jewels' intangibles, revisions are probable where the taxpayer's profits are substantially increased. This limits the utility of the safe harbour to the taxpayer.

The average APA takes 9 to 12 months to negotiate from the time of formal submission and payment of a US\$25,000 user fee until the signing of the agreement. Between 1991, when the program started, and April 1994, there have been 19 completed agreements (see Table 9.1). That is an average of seven agreements per year; clearly, this is not a very large number. At the same time, the number of firms approaching the Service about APAs is growing, increasing the workload of the APA staff, which already is, according to some analysts, at 'near saturation levels' (Brunori 1994, 975). As a result, the Service is attempting to streamline the process and may adopt a mini-APA for small companies. This form of alternative dispute resolution is likely to grow over time, as both parties see the benefits from the process.

*Binding Arbitration*¹⁵

Tax Court Rule 124

Domestic arbitration is available in the United States under Tax Court Rule 124, which allows the parties to a tax dispute to resolve items of fact by recourse to binding arbitration. Rule 124 states:

Rule 124: Voluntary Binding Arbitration

(a) Availability: The parties may move that any factual issue in controversy be resolved through voluntary binding arbitration. Such a motion may be made at any time after a case is at issue and before trial. Upon the filing of such a motion, the Chief Judge will assign the case to a Judge or Special Trial Judge for deposition of the motion and supervision of any subsequent arbitration. (Tax Court Rule 124, quoted in Wrappé [1994, 1594n. 132])

The rule was adopted by the U.S. government in September 1990 as an alternative to the court system's growing burden of fact-intensive transfer pricing cases. The rule establishes a procedure under which the taxpayer and the Internal Revenue Service can write their own agreements to submit disputes to arbitration. The parties must stipulate the factual issues to be resolved, along with various procedural issues. The essential elements of the U.S. arbitration procedure are that it is both voluntary and binding. To date, only one U.S. transfer pricing dispute has been settled through binding arbitration, but its success is likely to lead to others. We briefly review the case, the Apple arbitration decision, below.

The Apple Arbitration Decision

Apple Computer Inc. is a large multinational headquartered in California that designs, produces, markets, and services computers and computer-related products. Apple manufactures and assembles the printed circuit boards that go into its computers in its wholly owned subsidiary Apple Singapore.

The Internal Revenue Service audited Apple for the 1984-6 tax years and filed a transfer pricing adjustment totally US\$114.6 million.¹⁶ At issue was the income Apple Singapore would have earned at arm's length for manufacturing and assembling printed circuit boards. The IRS argued that too much income was retained in the Singapore subsidiary, and allocated its income, over and above the IRS's assessment of an arm's length charge, back to the parent Apple Computer. Apple challenged the adjustment. Instead of going through a long and costly trial, the firm and the IRS agreed to resolve the dispute through voluntary binding arbitration.

In early 1992, the two parties filed a stipulation agreement with the Tax Court which provided specific deadlines and procedures to be utilized both before and during the hearing. The arbitration panel was to consist of three persons, mutually agreed upon by the two parties. The hearings were limited to 60 calendar days or 30 hearing days. The panel was to file its findings with the Tax Court no more than 75 days after the close of the hearings. For each tax year at issue, the arbitration panel was to determine the proper amount of total income earned by Apple Singapore, regarding its printed circuit board and system manufacturing, taking into account sales, services, and intangible property transactions, if any, between Apple and Apple Singapore (*Tax Notes International* 1993a).

In the Apple case, the 'baseball (or pendulum) arbitration' approach was used. In baseball arbitration the two parties each submit a proposal and the arbitration panel must rule in favour of one number and reject the other. The parties' figures cannot be amended following their submission to the panel. The panel then

chooses one of the proposed numbers, rather than some midpoint figure. As a result, baseball arbitration pressures both sides to make reasonable proposals since only one proposal will be chosen and intermediate solutions are ruled out.

According to the stipulation agreement, each party was required to submit a single figure for the arm's length income of Apple Singapore for each year at issue. The single number 'shall not contain any clarification, caveat, discussion, argument or legal citation, nor make reference to any other document' (*Tax Notes International* 1993a). Both Apple and the IRS submitted the amount that each side believed Apple Singapore would have earned at arm's length for manufacturing and assembling circuit boards in 1984, 1985, and 1986. Whether the two sides offered baseball numbers that significantly narrowed the differences is unclear since Apple's numbers remained secret. The income figure the IRS recommended in arbitration was roughly two-thirds of the US\$114.6 million adjustment in the notice of deficiency.

A major concession by the government was to agree to shift the burden of proof given to the commissioner under section 482. Rather than Apple's having to prove that the IRS arbitrarily and capriciously came to the wrong deficiency number, under the arbitration agreement each side tried to prove that its income number for the Singapore subsidiary was closer to the arm's length result. Thus each side in the dispute was charged with defending the reasonableness of its own position rather than demonstrating the unreasonableness of the other side.

Both parties agreed that 'the transcript of the Arbitration Hearing and the evidence received by the Panel during the Arbitration Hearing shall be confidential and shall be sealed by order of the Tax Court' (Bergquist¹⁷ and Ryan 1993, 340). Even though the panel proceedings were confidential, the stipulation containing the final numbers to settle the case was to be open for public inspection. The IRS did not seek the confidentiality provision in the agreement, but allowed it because the proceedings would include information that Apple considered proprietary. According to Charles Triplett, IRS deputy associate chief counsel (*International*), 'Rather than dissect it as to what is confidential and what is not confidential, we decided to keep it all confidential' (*Tax Management Transfer Pricing Report* 1992a, 41). Triplett also said that while the IRS did not intend to lobby for secrecy provisions, it would consider taxpayers' requests for confidentiality when negotiating future arbitration agreements.

The two parties decided to constitute an arbitration panel consisting of a retired judge, an economist, and an industry expert. The experience of a retired judge was expected to help resolve discovery disputes and evidential objections, as well as evaluate relevant law and facts. The economist was expected to assist the panel in evaluating conflicting testimony offered by economists, and to evaluate whatever economic models the parties presented in defence of their

respective 'baseball' numbers. The industry expert was to bring an understanding of the personal computer industry and provide the panel with the necessary technical background.

The two sides exchanged lists of proposed arbitrators twice in May 1993 but no matches were found among the 30 candidates proposed. Apple and the IRS then brought in independent nominators and were finally able to agree on the arbitrator positions through negotiations involving the nominators. The three chosen arbitrators were retired judge Nicholas Bua, John Shoven, an economist and director of the Center for Economic Policy Research at Stanford University, and Paul Alder, a professor of business and manufacturing at the University of Southern California.

The evidence that could be considered by the panellists was an issue in the proceedings. The arbitration panel reportedly did not have access to Apple's tax returns or IRS administrative materials, such as the revenue agent's report and notices of deficiency (*Tax Notes International* 1993a). The parties disagreed as to whether the arbitrators could consider earlier court decisions and legal statutes in making their decision. The IRS wanted the panellists to be limited to resolving factual matters rather than interpreting law. Apple's counsel, on the other hand, felt that the panel would have to deal with some legal principles, such as locations savings, that were involved in legal decisions in other cases.¹⁸

The panel finished its work quickly, returning a decision 3 September 1993, two weeks after the hearings ended and well within the 75-day deadline set in the stipulation. The decision of the arbitration panel has not been made public. Charles Triplett noted that persons involved in the arbitration told him the process was 'fairly efficient, although it did take a lot of effort on the part of the Service – almost as much as it would have taken for a regular trial in terms of witnesses and the time involved' (quoted in Spevacek 1993, 292).

The court judge who oversaw the arbitration stated that the panel chose the IRS's baseball numbers for each of the tax years at issue. The panel's unanimous selection of the IRS numbers meant a US\$76 million transfer pricing adjustment to Apple's U.S. income for 1984–6 (Spevacek 1993, 291). This compares with an initial IRS assessment of US\$114.6 million. However, it would be misleading to call the decision an IRS victory, because the process led the IRS to modify its position so substantially. 'Apple may have lost the battle but won the war,' according to Fuller (1993b, 1041).

An Evaluation of Binding Arbitration

To evaluate binding arbitration as a dispute-settlement procedure, it is necessary to determine 'whether the arbitration achieved the stated goals of saving time and money, encouraging settlement, forcing parties to adopt reasonable opening

positions, and yielding a relatively quick decision' (Spevacek 1993, 291). With only one case to draw from, it is difficult to make predictions about the long-run usefulness of the procedure.

Binding arbitration did allow Apple to achieve many of the goals it sought: reduced cost, improved settlement opportunities, and a faster decision than otherwise would have been possible under normal Tax Court procedures. Apple's time-to-decision was significantly shortened compared with the time it would have taken had there been a traditional trial because there was no brief writing at the end of the arbitration hearings, and there was no lengthy wait while a Tax Court judge sorted out volumes of evidence and wrote a lengthy opinion. There also was no appeal. As a result, Apple's professional fees were estimated to be US\$4–5 million less than they would have been in a traditional trial setting. One additional significant benefit was the confidentiality of the proceedings, which most MNEs would prefer to having their activities detailed in public court documents and therefore open to competitors.

The Apple arbitration experience highlighted a number of advantages arbitration has over traditional Tax Court litigation (Bergquist and Ryan 1993; Spevacek 1993):

- *Focusing and narrowing of the issues:* Both parties committed to specific annual arm's length pricing amounts three months before trial, and no revisions or amendments to these 'baseball' numbers were permitted. This is in contrast to a number of recent section 482 court cases in which it seems that the IRS has put forth numerous revised positions immediately before and during trial.
- *Inducement to settle:* Submission of baseball numbers was a powerful inducement to serious settlement discussions that probably would not have taken place in a traditional litigation context. According to Fuller, 'the parties came reasonably close to settling the case even before the arbitration hearings began, as a result of each party's seeing the other party's "real" number' (Fuller 1993, 1041).
- *Widening of settlement discussions:* The parties stipulated that Appeals had the jurisdiction to settle the case up until the day before the arbitration hearing commenced. The parties attempted to resolve not only the principal 'Singapore issue' but collateral issues as well. Both sides recognized the advantage of achieving a resolution that could include settlement of the issue for future years.
- *Narrowing the differences:* The format allowed the parties to significantly narrow the numerical differences between them. Baseball arbitration encouraged each side to be reasonable in selecting its positions.

- *Reduced burden of proof concerns:* Neither side bore any burden of proof, for either its original position or any change from such position. Burden-of-proof concerns were eliminated by the stipulation: 'The parties have the burden of proving the appropriateness of each of the numbers they submit to the Panel ... Neither party has the burden of proving the inappropriateness of the numbers submitted by the opposing party' (Bergquist and Ryan 1993, 340).
- *Acceleration of the final decision:* Each of the revised baseball positions should have been within a range of reasonable results, thereby eliminating the necessity to reject both positions and craft a middle ground. No carefully worded opinion explaining the economics of such a judicially created economic result was required. Parties agreed that there would be no appeals on the merits. Neither party lodged any objections to the arbitration panel's findings, although either side was free to lodge objections with the Tax Court judge if it believed the stipulation was not adhered to. The parties also agreed that the stipulated decision would not go beyond the Tax Court judge, either as to the merits of the case or as to the novel procedures employed.

Arbitration, as used in the Apple case, has proved to be a viable process alternative to traditional tax court litigation. While it poses many uncertainties, arbitration also provides many advantages including reduced cost, improved settlement opportunities, and a much faster resolution of transfer pricing issues than what might be experienced in Tax Court. Abraham Shashy, former IRS chief counsel, said: 'There are lots of ways to structure alternative dispute resolution ... anything innovative that taxpayers and the government and the court can do to find different ways to resolve these cases is worth trying' (quoted in Spevacek 1993, 292). The ability to design the tax architecture to fit the case may yet be arbitration's greatest advantage.

Since the Apple decision, the IRS has announced that it is considering appeals-level arbitration (*Tax Notes International* 1994b, 803) for cases in which the Service and the taxpayer could not reach an agreement. The parties would share the costs of hiring a mutually agreed on, independent expert, and the expert's decision would be binding. This would be part of the Service's plan to speed up the appeals process and resolve cases before they go to litigation.

Conclusions

In this chapter and the previous one we outlined the history of the U.S. approach to taxing intracorporate trade under the Internal Revenue Code. Basically, the approach has three parts: transfer pricing rules under section 482, together with other related IRS regulations; administrative rules for penalties and enforce-