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RESOLVING LEGAL UNCERTAINTY:
THE UNFULFILLED PROMISE OF
ADVANCE TAX RULINGS

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RESOLVING LEGAL UNCERTAINTY: THE UNFULFILLED PROMISE OF ADVANCE TAX RULINGS

Yehonatan Givati^{*}

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Abstract: Advance tax rulings allow taxpayers to achieve certainty about the tax consequences of contemplated transactions, and are thus considered indispensable in the modern world of tax administration and compliance. After providing empirical evidence of tax law uncertainty, which should give rise to a demand for advance tax rulings, the article shows that advance tax rulings are in fact infrequently used. To explain this counterintuitive finding the article analyzes the taxpayers' strategic considerations when deciding whether to request an advance tax ruling. The strategic disadvantages of applying for an advance tax ruling are shown usually to outweigh the strategic advantages of such a request. Since the same strategic considerations apply when taxpayers decide whether to request an advance pricing agreement – a new procedure for resolving transfer pricing disputes – this analysis also explains why, despite considerable attention from scholars and practitioners in recent years, advance pricing agreements have been infrequently used, and are therefore unlikely to resolve the transfer pricing problem – probably the most significant problem in modern international taxation.

JEL Codes: K34, K23

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INTRODUCTION

Tax law is ambiguous in many cases. Different interpretations of the law are often possible, resulting in substantially different tax consequences. The inherent complexity of tax law and frequent changes in the law exacerbate this problem.

Legal uncertainty creates a problem for taxpayers. Uncertain tax consequences deter some taxpayers from carrying out contemplated transactions, while others who do carry out the transactions bear the risk of potential loss.

Advance tax ruling is a procedure that allows taxpayers to achieve certainty concerning the tax consequences of a contemplated transaction. Before carrying out a transaction, the taxpayer turns to the tax authorities for a binding ruling on the tax consequences of the transaction. In light of the ruling, the taxpayer decides whether the transaction should be carried out.

Considering the problem of legal uncertainty and its consequences given the magnitude of tax disputes,¹ most tax scholars see the advance tax ruling procedure as an indispensable tool in the modern world of tax administration and compliance. Accordingly, advance tax rulings have received considerable attention from tax scholars and practitioners in recent years.² Furthermore, the importance of the advance ruling procedure has been widely accepted by tax administrations around the world, and in recent years more and more countries have established an advance tax ruling system. In 1988 seven out of twenty OECD countries included in a survey did not provide an advance tax ruling procedure to their taxpayers.³ By 2005 only two out of the thirty OECD countries included in the survey did not provide such a procedure.⁴ In addition, twelve non-OECD countries

¹ For example, the prominent media company Tribune lost \$1 billion in a recent tax dispute. Joseph T. Hallinan, *Tribune Co. Loses \$1 Billion Tax Case*, THE WALL STREET JOURNAL, September 29, 2005; B3. See also *Tribune Co. v. Commissioner*, 125 T.C. No. 8 (9/27/2005). Tribune's appeal was settled later for a lower payment.

² See, e.g., CARLO ROMANO, ADVANCE TAX RULING AND PRINCIPLES OF LAW (2002); DANIEL SANDLER, A REQUEST FOR RULINGS (1994). In 1999 the International Fiscal Association dedicated its yearly congress to discuss the subject of advance tax rulings, publishing later a comparative study on this subject. *Advance Rulings*, 84(b) CAHIERS DE DROIT FISCAL INTERNATIONAL (Studies On International Fiscal Law) (1999). In 1997 an international guide to advance tax rulings was published, and since then it has been updated. THE INTERNATIONAL GUIDE TO ADVANCE RULINGS (Daniel Sandler and Ephraim Fuks eds., 1997-2003).

³ Austria, Belgium, France, Ireland, Japan, Switzerland and Turkey. TAXPAYERS' RIGHTS AND OBLIGATIONS 89 (Organization for Economic Co-operation and Development, 1990).

⁴ Luxembourg and Ireland (Luxembourg was not included in the 1988 survey).

included in the 2005 survey provided the procedure to their taxpayers.⁵

In view of the importance attributed to the advance tax ruling procedure by tax scholars and practitioners, and the adoption of such procedure by many countries around the world, one would expect to see frequent use of advance tax rulings. Yet, as this article shows, the use of the advance tax ruling procedure in the U.S. is surprisingly infrequent. This puzzle calls for a better understanding of the taxpayer's decision to apply for an advance tax ruling.

The taxpayer considers two general factors when deciding whether to apply for an advance tax ruling: the direct cost of an application and the strategic effect of an application. The direct cost of applying for an advance tax ruling includes the cost of preparing the request (the request fee and the lawyer's fee) and the waiting period. Although this cost could be significant, it does not suffice as a comprehensive explanation for the infrequent use of advance tax rulings. Therefore, the strategic effect of applying for an advance tax ruling must be analyzed.

When several interpretations of the law are possible, a taxpayer has a number of strategic reasons for choosing not to apply for an advance tax ruling. First, applying for a ruling dramatically increases the probability of inspection by the IRS, as audit rates are usually very low (around 1%), and applying for a ruling guarantees that the IRS will inspect the questionable transaction. Second, applying for an advance tax ruling significantly increases the probability of detection by the IRS, since even in industries where audit rates are very high the taxpayer expects some of the legally ambiguous tax issues to go undetected. By applying for an advance tax ruling the taxpayer "red flags" the ambiguous legal issues, guaranteeing that the IRS will consider them.

Third, advance tax rulings are issued by the IRS's national office, whereas tax audits are conducted by the IRS's district offices. Since agents at the national office have more expertise than agents at the district offices, they are less likely to make mistakes in their interpretation of the law. The taxpayer prefers more mistakes to fewer mistakes, however, since he benefits from mistakes that result in a lower tax obligation, while mistakes that result in a higher tax obligation can be corrected.

Fourth, if a favorable interpretation of the law is expected to decrease future tax revenue, the IRS will be more reluctant to adopt such an interpretation in an advance tax ruling than in a tax audit.

CENTRE FOR TAX POLICY AND ADMINISTRATION, TAX ADMINISTRATION IN OECD AND SELECTED NON-OECD COUNTRIES 87 (Organization for Economic Co-operation and Development, 2006).

⁵ Argentina, Brazil, Chile, China, Cyprus, Estonia, India, Latvia, Lithuania, Malta, Singapore and South Africa.

Advance rulings have a *de facto* precedential effect, since they are all published and easily accessible, and the IRS has a duty of consistency toward similarly situated taxpayers. Decisions by the IRS in a tax audit have no precedential effect, by contrast, since they remain unknown to the public.

Fifth, carrying out the transaction without an advance tax ruling can, in some cases, guarantee a favorable interpretation in the tax audit. By carrying out the transaction the taxpayer relinquishes the option to forgo the transaction following an adverse ruling, and commits to appealing an adverse decision in the tax audit. If the IRS is reluctant to take the case to court, it will be forced to decide favorably.

There are also two strategic reasons a taxpayer may choose to apply for an advance tax ruling. First, by applying for a ruling the taxpayer avoids penalties for not complying with the law. However, as the article shows, when several interpretations of the law are possible, applying the favorable interpretation will not expose the taxpayer to a real risk of penalty, whether criminal or civil. Second, the taxpayer applying for an advance tax ruling threatens to forgo the contemplated transaction and carry out an alternative transaction if an adverse ruling is issued, in which case the IRS might collect less tax. Applying for an advance tax ruling, then, may force the IRS to issue a favorable ruling. Nevertheless, this effect is limited to cases where the IRS expects to collect less tax from the alternative transaction.

The analysis concludes that the strategic disadvantages of applying for an advance ruling usually outweigh the strategic advantages of such a request. That taxpayers usually reach a similar conclusion when deciding whether to apply explains the infrequent use of advance tax rulings in the U.S.

The infrequent use of advance tax rulings in the U.S. raises doubts about the importance attributed to this procedure by tax scholars and practitioners. These doubts are particularly significant for a similar procedure that was introduced in recent years for dealing with the uncertainty of transfer pricing enforcement – the advance pricing agreement.

Transfer pricing, probably the most significant problem in modern international taxation,⁶ utilizes tax arbitrage between related companies to minimize tax payments. By setting the transfer prices of international

⁶ 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, 91 (1995) ("The transfer pricing problem is . . . one of the major international tax policy challenges for the coming century."); see also J. Philip Van Hilten, *Transfer Pricing Policy in the International Tax System*, 10 GEO. MASON L. REV. 709, 709 (2002) ("Transfer pricing is . . . one of the most fundamental tax problems facing both tax administration and businesses not only today, but also in the years to come.").

transactions between related companies, income is shifted to the legal entity located in a low tax rate jurisdiction, and tax payments are thereby reduced. In order to prevent the erosion of the tax base, tax authorities require inter-company international transactions to be priced at arm's length price. However, the arm's length principle is difficult to employ in many cases due to the scarcity of comparable transactions, leading to frequent controversy between taxpayers and tax authorities, and significant uncertainty regarding a corporation's ultimate tax liabilities.

An advance pricing agreement, negotiated between the taxpayer and the tax authorities, determines the appropriate transfer pricing method for future inter-company international transactions. This agreement can prevent controversy and mitigate the risk of double taxation.

Advance pricing agreements were introduced in the U.S. in 1991,⁷ and have attracted much attention and high expectations from scholars and practitioners.⁸ Following the introduction of these agreements in the U.S., similar procedures were gradually adopted in other countries, and by 2007 advance pricing agreements were offered in many countries around the world.⁹

Considering the transfer pricing problem and its implications given the

⁷ Rev. Proc. 91-22, 1991-11 I.R.B. 11.

⁸ See, e.g., Diane M. Ring, *On the Frontier of Procedural Innovation: Advance Pricing Agreements and the Struggle to Allocate Income for Cross Border Taxation*, 21 MICH. J. INT'L L. 143, 155 (2000); Anja De Waegenaere, Richard Sansing & Jacco L. Wielhouwer, *Using Bilateral Advance Pricing Agreements to Resolve Tax Transfer Pricing Disputes*, 60 NAT. TAX J. 173 (2007); Akinori Tomohara, *Inefficiencies of Bilateral Advanced Pricing Agreements (BAPA) in Taxing Multinational Companies*, 57 NAT. TAX J. 173 (2004); Avi-Yonah, *supra* note 6, at 154-156; Fred B. Brown, *Federal Income Taxation of U.S. Branches of Foreign Corporations: Separate Entity or Separate Rules?*, 49 TAX L. REV. 133, 182-183 (1993); David R. Tillinghast, *Issues of International Tax Enforcement, in THE CRISIS IN TAX ADMINISTRATION* 38, 43-44 (Henry J. Aaron & Joel Slemrod eds., 2004) ("Most observers would say that the APA [Advance Pricing Agreement] program has been a great success"); David Brunori, *Advance Pricing Agreement Program is Getting High Marks*, 63 TAX NOTES 139 (April 11, 1994) ("[T]he APA [Advance Pricing Agreement] program. . . has alleviated virtually all of the serious problems encountered in resolving transfer pricing cases"); Steven C. Warppe, *Advance Pricing Agreements: The IRS Rediscovered Alternative Dispute Resolution*, 63 TAX NOTES 1343 (June 6, 1994); Robert E. Ackerman et al., *The Advance Pricing Agreement (APA) Program: A Model of Alternative Dispute Resolution Process*, 9 TAX MANAGEMENT TRANSFER PRICING SPECIAL REPORT (Dec. 1, 1993); Barbara N. McLennan, *Responses to Section 482 Litigation: Advance Pricing Agreements or Arbitration?*, 54 TAX NOTES 431 (January 27, 1992).

⁹ A recent global survey showed that 25 out of 41 surveyed countries had instituted formal procedures for obtaining Advance Pricing Agreements. The list includes countries such as: Australia, Belgium, Canada, France, Germany, Italy, Japan, Malaysia, Mexico, Netherlands, Peru, Singapore, Spain, Thailand, Turkey and the United Kingdom. ERNST & YOUNG, TRANSFER PRICING GLOBAL REFERENCE GUIDE (Feb. 2008).

magnitude of transfer pricing disputes,¹⁰ the attention that the advance pricing agreement procedure has attracted from tax scholars and practitioners, and the adoption of similar procedures worldwide, one would expect to see frequent use of advance pricing agreements. However, this article shows the surprisingly infrequent use of advance pricing agreements in the U.S. Since the strategic disadvantages and advantages of applying for advance tax rulings are shown to apply also to the case of advance pricing agreements, it is clear why these agreements are infrequently used. It follows that one should not expect to see a significant growth in the number of applications for advance pricing agreements in coming years. The introduction of advance pricing agreements will therefore not serve to resolve the transfer pricing problem.

The article proceeds as follows. Part I provides empirical evidence of tax law uncertainty, which should give rise to a demand for advance tax rulings, and presents scholars' view of the importance of the advance tax ruling procedure for taxpayers. Part II provides data on the infrequent use of advance tax rulings in the U.S. Part III discusses the cost of applying for an advance tax ruling. Part IV analyzes the taxpayer's strategic consideration when deciding whether to apply for an advance tax ruling. Part V discusses the implications of the analysis in the article for advance pricing agreements, presenting data on the infrequent use of these agreements.

I. THE IMPORTANCE OF ADVANCE TAX RULINGS

A. *Tax Law Uncertainty*

Tax law, like many other areas of the law, is not determinate in many cases.¹¹ There are three types of possible ambiguities in tax law: ambiguity concerning the precise meaning of statutory language, ambiguity concerning the application of the law to a specific factual situation, and ambiguity concerning the type of evidence sufficient to establish necessary facts.¹²

¹⁰ For example, a recent tax dispute on transfer pricing by the leading pharmaceutical company GlaxoSmithKline was settled for \$3.4 billion. Audrey Nutt, *Glaxo, IRS Settle Transfer Pricing Dispute for \$3.4 Billion*, TAX NOTES TODAY, September 12, 2006.

¹¹ For the general debate among jurisprudential scholars concerning the determinacy of law see, e.g., Anthony D'Amato, *Pragmatic Indeterminacy*, 85 NW. U. L. REV. 148 (1990); Kent Greenawalt, *How Law Can Be Determinate*, 38 UCLA L. REV. 1 (1990); Ken Kress, *Legal Indeterminacy*, 77 CAL. L. REV. 283 (1989); Frederick Schauer, *Formalism*, 97 YALE L. J. 509 (1988).

¹² Susan B. Long & Judyth A. Swingen, *Taxpayer Compliance: Setting New Agendas for Research*, 25 LAW & SOCIETY REVIEW 637, 646 - 647 (1991); CENTRE FOR TAX POLICY AND ADMINISTRATION, OECD, COMPLIANCE MEASUREMENT - PRACTICE NOTE, 4 (2001).

The complexity of tax law that has attracted much attention in recent years,¹³ is an important factor in this regard. While some scholars emphasize the effect of tax law complexity on compliance costs,¹⁴ it is evident that tax law complexity also affects legal certainty.¹⁵ Likewise, the frequent changes in tax law are another source of tax law uncertainty.¹⁶ To illustrate, between 1954 and 2001 over 500 public laws made changes to the tax law, each typically changing several Internal Revenue Code sections covering a number of different areas of the Code.¹⁷ Furthermore, the reliance on general anti-avoidance doctrines, such as the economic substance doctrine, also introduces significant uncertainty to tax law.¹⁸

Evidence of tax law uncertainty can be shown. In a study attempting to

¹³ For reference to the literature on this subject see Deborah H. Paul, *The Source of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151, 153 - 154 nn.3 - 4 (1997).

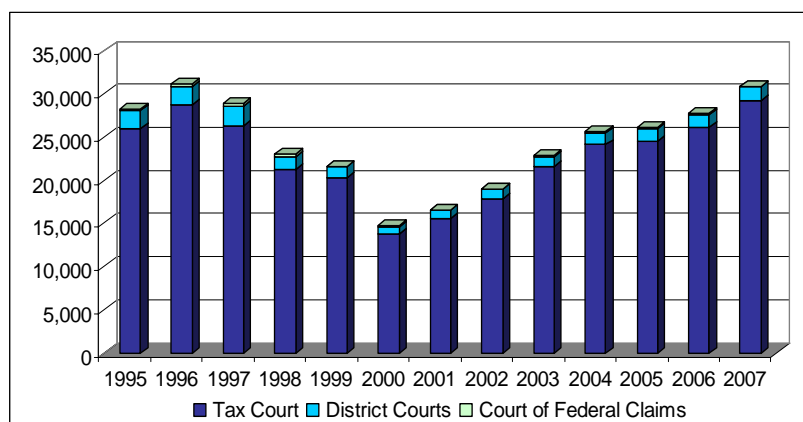
¹⁴ See Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L. J. 261 (2002); Scott A. Hodge, J. Scott Moody & Wendy P. Warcholik, *The Rising Cost of Complying with the Federal Income Tax*, 138 TAX FOUNDATION SPECIAL REPORT (December 2005); THE PRESIDENT'S ADVISORY PANEL ON FEDERAL TAX REFORM, Final Report, 2 - 3 (2005); Stanley A. Koppelman, *At-Risk and Passive Activity Limitations: Can Complexity be Reduced?*, 45 TAX L. REV. 97, 100 (1989)

¹⁵ See Michelle J. White, *Why are Taxes so Complex and Who Benefits?*, 47 TAX NOTES 341 (April 16, 1990); Boris I. Bitter, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 7 (1974); Koppelman, *id.* at 100 (referring to planning complexity); Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1271 (1990) ("Even if a taxpayer can read and understand a given tax rule, she may be unable to apply it to her affairs with any confidence, or to recognize the likely tax results of decisions regarding investments or other economic actions."); Edward Andersson, *General Report*, 50(b) CAHIERS DE DROIT FISCAL INTERNATIONAL (Studies On International Fiscal Law) 7, 25 (1965) (noting that "the complexity of fiscal legislation is constantly increasing in all countries and for this reason it has become increasingly difficult for the taxpayers to obtain reliable information concerning the application of the tax law, which is a prerequisite for all financial estimates.")

¹⁶ Ronald A. Pearlman, *The Tax Legislative Process: 1972-1992*, 57 TAX NOTES 939 (1992) ("[T]axpayers, as well as tax professionals both within and outside government, have been overwhelmed by the thousands of changes in the law.")

¹⁷ JOINT COMMITTEE ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, Vol. I, at 63.

¹⁸ BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶1.03[3] (3rd ed., 2002) ("it is almost impossible to distill useful generalizations from the welter of substance over form cases."). Similarly, when discussing the economic substance doctrine, Sen. Carl Levin noted that "because there is no statute underlying this doctrine and the courts have developed and applied it differently in different judicial districts, the existing case law has many ambiguities and conflicting interpretations." Sen. Carl Levin, Senate Floor Statement on Introducing the Tax Shelter and Tax Haven Reform Act, July 29, 2005. <http://levin.senate.gov/newsroom/release.cfm?id=242229>

Figure 1: Tax Cases Filed 1995 – 2007

Source: Tax Court data: Provided by the Office of the Clerk of the Tax Court. District Court and Court of Federal Claims data: Judicial Business of the United States Courts (<http://www.uscourts.gov/judbususc/judbus.html>) 1995 Annual Report of the Director through 2007 Annual Report of the Director, Supplemental Tables C-2A and G-2A.

measure tax law complexity, tax professionals were asked to rank the factors of tax complexity. The respondents ranked ambiguity (defined as a situation where “there are ambiguities in the law which may lead to more than one defensible position”) as the third most important factor of tax law complexity.¹⁹ For certain line items in a tax return the most frequently cited complexity factor by the tax professionals was ambiguity.²⁰

Another finding that is consistent with the existence of tax law uncertainty is the number of tax cases filed each year. A taxpayer can appeal a ruling by the federal tax authorities in three different courts: the U.S. Tax Court,²¹ a federal district court,²² and the U.S. Court of Federal Claims.²³ Figure 1 shows the number of tax cases filed in these courts during the years 1995 - 2007.

The fluctuation in the number of tax cases filed shown in figure 1 calls for further research. However, the overall high number of tax cases filed is consistent with the claim that there is significant legal uncertainty in federal tax law.²⁴

¹⁹ Susan B. Long and Judyth A. Swingen, *An Approach to the Measurement of Tax Law Complexity*, 8 JOURNAL OF THE AMERICAN TAXATION ASSOCIATION 22, 25, 29 - 30 (1987).

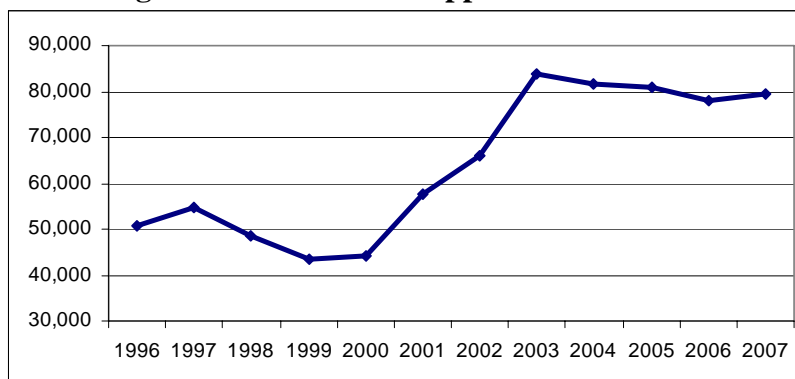
²⁰ *Id.* at 31.

²¹ 26 U.S.C. §§ 7441 – 7479.

²² 28 U.S.C. § 1340.

²³ 28 U.S.C. § 1491(a)(1).

²⁴ Although some tax disputes involve a high degree of factual specificity, at least one

Figure 2: Internal Tax Appeals 1996 – 2007

Source: Appeals in which the taxpayer has not filed a petition in the United States Tax Court, taken from INTERNAL REVENUE SERVICE DATA BOOK 1996 through INTERNAL REVENUE SERVICE DATA BOOK 2005, Table 17 (Appeals Workload, by Status and Type of Case). The figures for 2006 and 2007 were obtained from the Statistical Information Service of the IRS.

Furthermore, not all federal tax cases end up in court. When a taxpayer disagrees with the result of a tax audit, he may request a conference with the Appeals Office.²⁵ This conference serves as an internal appeal on the decision of the tax auditor. The number of internal tax appeals filed in the years 1996 - 2007 is shown in figure 2.

If there were very little uncertainty concerning the tax law, we would expect to see only a small number of disagreements between the taxpayers and the tax auditors, and consequently a small number of internal appeals. Accordingly, the relatively high number of internal appeals shown in figure 2, and the fact that the number of internal appeals is rising, are consistent with the uncertainty of tax law.

Given the problem of tax law uncertainty, the advance tax rulings procedure seems especially promising, since through it legal uncertainty can be resolved.

B. Scholars' View

The importance of advance tax ruling is evident both in the professional and the academic tax literature. The advance ruling process is understood to be important for many reasons, but especially because taxpayers can

type of legal ambiguity, broadly defined in the beginning of this section, is usually involved in those disputes, i.e. ambiguity concerning the precise meaning of statutory language, the application of the law to a specific factual situation, or the type of evidence sufficient to establish the necessary facts.

²⁵ Robert E. Meldman & Richard J. Sideman, *FEDERAL TAXATION* 331 (6th ed. 2001).

achieve legal certainty regarding the tax consequences of contemplated transactions by using it.

The importance of advance tax ruling for coping with legal uncertainty was stressed by the former commissioner of the Internal Revenue Service, Mortimer Caplin, who noted in 1962 that “with complex tax laws and high tax rates, it is understandable why taxpayers frequently hesitate to move on important business transactions without some official assurance of the tax consequences.”²⁶

The issue of advance tax ruling has been discussed by the International Fiscal Association in its yearly congresses. Before each congress the International Fiscal Association conducts a comparative study on the subject to be discussed at the congress. The general report of the 1965 study on Advance Ruling by the Tax Authorities at the Request of a Taxpayer notes that the uncertainty about the tax consequences of many transactions due to the increased complexity of fiscal legislation may hold back economic activity.²⁷ Thus, according to the report, “it is of utmost importance that taxpayers are provided with a possibility to obtain an authoritative opinion on the constructions of the provisions in force already before taking measures the fiscal consequences of which are uncertain.”²⁸

A study conducted by the OECD in 1988 on taxpayers’ rights and obligations asserts the taxpayers’ right to a high degree of certainty as to the tax consequences of their actions.²⁹ The study emphasizes the importance of advance tax rulings in this respect, noting that “such rulings are attractive for taxpayers since they enable them to evaluate correctly and with certainty the tax consequences of those actions.”³⁰

A 1995 comparative study on advance tax ruling emphasizes the great benefits of an advance tax ruling system for taxpayers.³¹ According to the study, an advance tax ruling system is important because “planning uncertainty is anathema to taxpayers whose commercial activities pivot on reliable assumptions of potential costs and benefits of prospective arrangements.”³²

The general report of the 1999 International Fiscal Association study on Advance Ruling notes that “Without exception, all reporters subscribe to the need for rulings. If there is a message emanating from their collective work,

²⁶ Mortimer M. Caplin, *Taxpayer Ruling Policy of the Internal Revenue Service: A Statement of Principles*, 20 N.Y.U. TAX INST. 1 (1962).

²⁷ Andersson, *supra* note 15, at 7-8.

²⁸ *Id.* at 25.

²⁹ TAXPAYERS’ RIGHTS AND OBLIGATIONS, *supra* note 3, at 12.

³⁰ *Id.* at 13.

³¹ Jason Chang et. al., *Private Income Tax Ruling: A Comparative Study*, 10 TAX NOTES INT’L 738, 739 (Feb. 27, 1995).

³² *Id.*

it is that advance rulings are an indispensable tool in the modern world of tax administration and compliance.”³³ The report notes several reasons for the importance of advance tax ruling for taxpayers that have to do with the need for certainty concerning the tax consequences of transactions.³⁴ The reasons for the increased uncertainty that are mentioned in the report are the increase in mass and complexity of tax statutes,³⁵ as well as the introduction of general anti-avoidance legislation, that by its nature could reach transactions that have a perfectly legitimate business purpose.³⁶

In a more recent publication, Professor Sandler claims that the advantages of advance rulings to taxpayers are apparent, since an advance ruling “provides certainty regarding the consequences of particular transactions, and thus decisions can be taken with knowledge of their true cost.”³⁷ Accordingly, in cases where

taxpayers require an accurate assessment of the tax consequences of a transaction in order to determine its viability. . . taxpayers would generally prefer to disclose all of the relevant facts to the authorities in advance in order to obtain a ruling regarding the tax consequences, rather than proceed with the transaction and risk an adverse assessment.³⁸

Other sources may be cited,³⁹ but one can see from the above survey that the common view among scholars is that the advance tax ruling procedure is an indispensable procedure for taxpayers.

II. ADVANCE TAX RULINGS IN THE U.S.

The U.S. Internal Revenue Service provides advance tax rulings for taxpayers inquiring about the tax effects of contemplated acts or

³³ Maarten J. Ellis, *General Report*, 84(b) CAHIERS DE DROIT FISCAL INTERNATIONAL (Studies On International Fiscal Law) 21, 24 (1999).

³⁴ *Id.* at 24.

³⁵ *Id.* at 24-25.

³⁶ *Id.* at 25.

³⁷ Daniel Sandler, General Introduction to THE INTERNATIONAL GUIDE TO ADVANCE RULINGS vii, ix (Daniel Sandler and Ephraim Fuks eds., 6th Suppl. 2001).

³⁸ *Id.* at ix.

³⁹ See, e.g., Sandler, *supra* note 2, at 1-4 (on page 3: “Given the uncertainty in the application of tax legislation, taxpayers must have access to some procedure whereby they may obtain a degree of certainty in the arrangement of their affairs”); John Prebble, ADVANCE RULING ON TAX LIABILITIES 21-28 (1986); Norman S. Sugarman, *Federal Tax Ruling Procedure*, 10 TAX L. REV. 1, 5 (1955) (noting that one of the purposes which advance tax rulings serve is “to provide certainty as an aid to business and other elements of our economy.”).

transactions.⁴⁰ This guidance takes the form of private letter rulings, also known as letter rulings.⁴¹ As defined by the IRS, a “ruling is a written statement issued to a taxpayer or his authorized representative by the National Office which interprets and applies the tax laws to a specific set of facts.”⁴²

The IRS publishes an annual Revenue Procedure detailing the exact procedure for requesting a private letter ruling, and explaining how these requests are handled by the IRS.⁴³ According to the revenue procedure, when applying for a letter ruling, the taxpayer has to provide his personal information, a complete statement of facts relating to the transaction, and other information regarding his business operation.⁴⁴ The taxpayer may request a conference regarding a letter ruling request.⁴⁵ The ruling, whether favorable or adverse, is sent to the appropriate official in the operating division that has examination jurisdiction of the taxpayer’s tax return.⁴⁶ The taxpayer may rely on the letter ruling, as long as the transaction is carried out substantially as proposed.⁴⁷

Given the common view among scholars on the importance of advance tax rulings for taxpayers, and the evidence on tax law uncertainty, one would expect to find a large number of private letter rulings in the U.S. Figure 3 shows the number of private letter rulings issued in the U.S. during the years 1980 - 2007.⁴⁸

⁴⁰ 26 C.F.R. § 601.201(a)(1).

⁴¹ For an overview of the history of the private letter ruling program see Donald E. Osteen, Lori J. Jones & Howard S. Fisher, *The Private Letter Ruling Program at the Half Century Mark*, 42 U.S.C. LAW CENTER TAX INSTITUTE 12-1, 12-11 - 12-15 (1990).

⁴² 26 C.F.R. § 601.201(a)(2).

⁴³ See, e.g., Rev. Proc. 2007-1, 2007-1 I.R.B. 1; Rev. Proc. 2006-1, 2006-1 I.R.B. 1; Rev. Proc. 2005-1, 2005-1 I.R.B. 1. For an overview of the advance tax ruling procedure see Donald E. Osteen & Nelson F. Crouch, *Obtaining Private Guidance from the Internal Revenue Service*, 55 U.S.C. LAW CENTER TAX INSTITUTE 17-1 (2002); Robert Culbertson & Christine Halphen, *Unites States*, 84(b) CAHIERS DE DROIT FISCAL INTERNATIONAL (Studies On International Fiscal Law) 627 (1999).

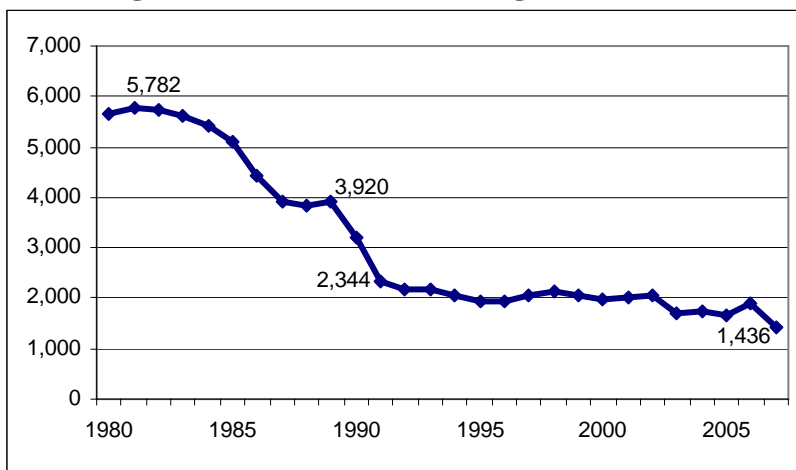
⁴⁴ Rev. Proc. 2007-1, *supra* note 43, § 7.01(1). This means that a request for private letter ruling cannot be made without revealing the taxpayer’s identity.

⁴⁵ *Id.* § 10.01. Since a request can be withdrawn at any time before the letter ruling is signed (*id.* § 7.07(1)), if the taxpayer understands at the conference that an adverse ruling is forthcoming, the common practice is to withdraw the request. Steven R. Lainoff, *Perspective of the United States of America*, in ADVANCE RULING: PRACTICE AND LEGALITY 29, 36 n.25 (1994). However, following a withdrawal the appropriate service official in the operating division that has examination jurisdiction over the taxpayer’s tax return is notified about the tentatively ruling, and it is taken into account in any later examination of the return. Rev. Proc. 2007-1, *supra* note 43, § 7.07(2)(a).

⁴⁶ Rev. Proc. 2007-1, *supra* note 43, § 8.09.

⁴⁷ *Id.*, § 11.01 and § 11.03.

⁴⁸ Note that figure 3 shows the number of private letter ruling issued, and not the

Figure 3: Private Letter Rulings 1980 – 2007

Methodology: Search Lexis-Nexis IRS Private Letter Rulings and Technical Advice Memoranda database for “private letter ruling and not (technical advice memorandum)”. For similar figures see Sheryl Stratton & Judy Parvez, *IRS Guidance 1980-2003: An Ever Changing Landscape*, 105 Tax Notes 985, 987 (Nov. 15, 2004). See also: Marion Marshall et al., *The Changing Landscape of IRS Guidance: A Downward Slope*, 90 Tax Notes 673 (Jan. 29, 2001)

The number of private letter rulings was relatively low in the 1980s, and this number has significantly decreased, from 5,782 in 1981 to 1,436 in 2007.⁴⁹ These figures seem relatively low when compared with the total number of tax cases presented earlier in figure 1, and even more so when compared with the number of internal tax appeals presented earlier in figure 2. In 2007, 30,869 tax cases were filed in different courts and 79,479 internal tax appeals were filed, but only 1,436 private letter rulings were issued. One would expect the number of advance tax rulings to be much

number of requests for private letter rulings. This distinction is important since, as noted in note 45, the private letter ruling procedure allows the taxpayer to withdraw his request at any time. After contacting the Legal Processing Division of Procedure & Administration at IRS Chief Counsel, I was told that the data collected by the IRS on private letter ruling requests are not broken down by year. Nevertheless, cumulative data for the years 2002 - 2006 were given. According to these data, the average yearly number of private ruling requests for that period was 1,652 (excluding technical requests for a change in the accounting method or a change in the accounting period, which are processed as rulings but are not published). The average yearly number of published rulings for that period was 1,332. The difference between these numbers was attributed to 320 yearly requests that were withdrawn.

⁴⁹ Culbertson and Halphen claim that in 1997 the IRS issued 51,075 letter rulings. Culbertson & Halphen, *supra* note 43, at 627. This number seems clearly erroneous, as was noted in Romano, *supra* note 2, at 18 note 30. Perhaps Culbertson and Halphen included technical requests for a change in the accounting method or in the accounting period in their data. For similar numbers to the ones presented in figure 3 for the year 1993 see Chang et al., *supra* note 31, at 741.

higher, especially since one can file a letter ruling request for a transaction that is highly risky from a tax perspective, just for the small chance that a favorable ruling will be issued. The relatively small number of private letter rulings seems to contradict the scholars' view on the importance of the advance tax ruling procedure for taxpayers.

Two possible forms of explanations to this contradiction will now be pursued. First, the cost of applying for an advance tax ruling is addressed, since a possible explanation for the infrequent use of advance tax rulings is that applying for a ruling is too costly. Then, after showing that the cost of requesting an advance tax ruling does not offer a comprehensive explanation for the small number of rulings, the taxpayer's strategic considerations when deciding whether to apply for an advance tax ruling are analyzed.

III. THE COST OF APPLYING FOR AN ADVANCE TAX RULING

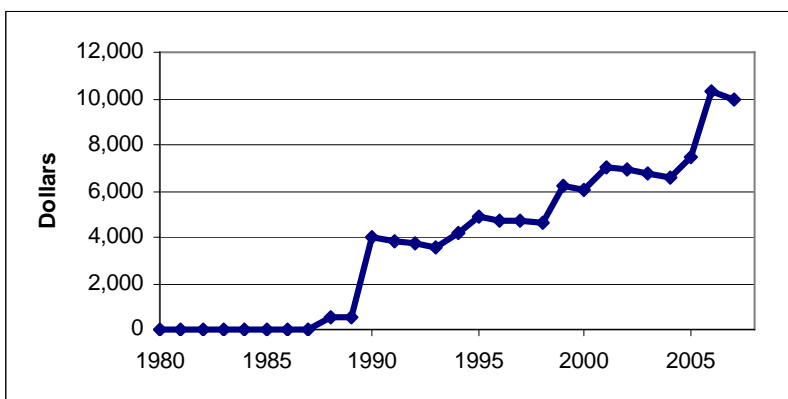
Three factors affect the cost of applying for a letter ruling: the cost of preparing the letter ruling request, the request fee and the waiting period.

The cost of professional advice to obtain a letter ruling is usually thought of as being considerable.⁵⁰ Nevertheless, one must remember that tax advice is usually obtained regardless of whether a letter ruling is sought. Therefore the relevant cost is only the additional cost that one has to pay for preparing a letter ruling request, and not the total cost of the tax advice. Since the request usually relies on the research that was done for the tax advice, it is unclear if the additional cost of preparing the request is indeed substantial.

Let us now turn to the request fee. Figure 4 shows the change in the request fee for private letter rulings since 1980. According to figure 4 there was a significant increase in the request fee for private letter rulings, from no fee until 1987 to \$10,000 in 2007 (in 2007 dollars). Although the increase in the request fee for private letter rulings could explain part of the decrease in the number of yearly rulings, this increase does not seem to offer a comprehensive explanation for the overall small number of letter rulings, for several reasons. First, no fee was charged until 1987, and the fee did not exceed \$600 until 1990. During that period there were still a relatively small number of rulings (3,920 in 1989). Second, there was a great increase in the request fee from 1990 to 2007 (from \$3,966 in 1990 to \$10,000 in 2007) but, as figure 3 shows, the number of rulings was more or

⁵⁰ Charles S. Triplett & Brian P. Trauman, *United States* 50, in *THE INTERNATIONAL GUIDE TO ADVANCE RULING* (Daniel Sandler and Ephraim Fuks eds., 9th Suppl. 2003); MICHAEL I. SALTZMAN, *IRS PRACTICE AND PROCEDURE* ¶3.03[3][b] (Revised 2nd ed. 2002-2007).

**Figure 4: Private Letter Ruling Request Fee 1980 - 2007
(2007 Dollars)**



Source: Rev. Proc. 87-1, 1987-1 I.R.B. 7; Rev. Proc. 88-8, 1988-1 I.R.B. 7; Rev. Proc. 89-1, 1989-1 I.R.B. 8; Rev. Proc. 90-1, 1990-1 I.R.B. 8; Rev. Proc. 90-17, 1990-12 I.R.B. 13; Rev. Proc. 91-1, 1991-1 I.R.B. 9; Rev. Proc. 92-1, 1992-1 I.R.B. 9; Rev. Proc. 93-1, 1993-1 I.R.B. 9; Rev. Proc. 94-1, 1994-1 I.R.B. 10; Rev. Proc. 95-1, 1995-1 I.R.B. 9; Rev. Proc. 96-1, 1996-1 I.R.B. 8; Rev. Proc. 97-1, 1997-1 I.R.B. 11; Rev. Proc. 98-1, 1998-1 I.R.B. 7; Rev. Proc. 99-1, 1999-1 I.R.B. 6; Rev. Proc. 2000-1, 2000-1 I.R.B. 4; Rev. Proc. 2002-1, 2002-1 I.R.B. 1; Rev. Proc. 2003-1, 2003-1 I.R.B. 1; Rev. Proc. 2004-1, 2004-1 I.R.B. 1; Rev. Proc. 2005-1, 2005-1 I.R.B. 1; Rev. Proc. 2006-1, 2006-1 I.R.B. 1; Rev. Proc. 2007-1, 2007-1 I.R.B. 1; The data are for fees for advance ruling requests defined as "all other ruling requests." When a fee was changed in the middle of the year the fee that was attributed to that year was the effective fee in the majority of the months of that year. Prices are in 2007 dollars, calculated based on the Consumer Price Index for All Urban Consumers (Bureau of Labor Statistics <http://data.bls.gov/cgi-bin/surveymost?cu>).

less constant from 1993 through 2006. Third, when the request fee increased dramatically in 1990, a significantly lower fee for taxpayers with income under a certain threshold was introduced, leaving the regular fee for taxpayers with relatively high income.⁵¹

Another factor affecting the cost of applying for a private letter ruling is the period of time that a taxpayer has to wait until a formal ruling is issued. Private letter rulings are rarely obtained in less than 90 days, many are issued within 90 to 183 days, and some requests involving a complex factual situation or a novel issue may take anywhere from six months to a year.⁵² However, it should be noted that within 21 days after a letter ruling request has been received an IRS official meets with the taxpayer, and informs him, when possible, whether a favorable or an adverse ruling will

⁵¹ In 1990 the request fee for individuals, trusts, and estates with a total income of less than \$150,000 was \$500 (Rev. Proc. 90-17, 1990-12 I.R.B. 13). In 2003 the request fee for a person with gross income of less than \$250,000 was \$500 (Rev. Proc. 2003-1, 2003-1 I.R.B. 1).

⁵² Culbertson & Halphen, *supra* note 43, at 635.

be recommended.⁵³ Thus, even if a formal ruling is issued after a long period of time, in many cases the taxpayer will know the expected ruling within 21 days, and could adjust his behavior accordingly.

In sum, it seems that the cost of applying for a private letter ruling has an effect on the number of private letter rulings issued, but this cost does not offer a comprehensive explanation for the infrequent use of private letter rulings.

IV. STRATEGIC ANALYSIS OF THE DECISION TO APPLY FOR AN ADVANCE TAX RULING

Suppose a taxpayer considers a certain transaction. There is legal ambiguity concerning the amount of tax that has to be paid on this transaction. The law could be interpreted in a way that is favorable to the taxpayer, which means that low tax would be paid, or in an adverse way, which means that high tax would be paid. The taxpayer has to decide whether to request an advance tax ruling before carrying out the transaction, or to apply the favorable interpretation of the law and carry out the transactions without an advance tax ruling.

This part analyzes the taxpayer's strategic considerations when deciding whether to apply for an advance tax ruling. Some of the arguments made in this part consider how the IRS chooses its interpretation of an ambiguous law.⁵⁴ For those arguments it is assumed that when interpreting an ambiguous law the IRS takes into consideration the effect of its decision on tax revenue, both in the present and in the future. This is not to say that the effect of its decisions on tax revenue is the IRS's only consideration, but rather that it is one of its considerations. This assumption seems plausible, since the IRS appears to be concerned about increasing total tax revenue, as demonstrated by its yearly statements on enforcement results.⁵⁵

⁵³ Rev. Proc. 2007-1, *supra* note 43, § 8.02. *See also* Triplett & Trauman, *supra* note 50, at 46.

⁵⁴ Administrative agencies' choice of statutory interpretation has been analyzed formally in : Matthew Stephenson, *The Strategic Substitution Effect: Textual Plausibility, Procedural Formality, and Judicial Review of Agency Statutory Interpretations*, 120 HARV. L. REV. 528 (2006); Yehonatan Givati, *Strategic Statutory Interpretation by Administrative Agencies*, Harvard Law School John M. Olin Fellows Discussion Paper 16 (2008). More broadly, the interaction between Congress, the president, an administrative agency and the court concerning statutory interpretation has been analyzed in: William N. Eskridge, Jr. and John Ferejohn, *Making the Deal Stick: Enforcing the Original Constitutional Structure of Lawmaking in the Modern Regulatory State*, 8 J. L. ECON. & ORG. 165 (1992); John A. Ferejohn and Barry R. Weingast, *A Positive Theory of Statutory Interpretation*, 12 INT'L REV. L. & ECON. 263 (1992); Linda R. Cohen and Matthew L. Spitzer, *Solving the Chevron Puzzle*, 57(2) LAW & CONTEMP. PROB. 65 (1994).

⁵⁵ *See, e.g.*, Commissioner Mark W. Everson's statement on Fiscal Year 2006

Furthermore, despite specific prohibition on using enforcement results when evaluating employees,⁵⁶ there is a widespread perception among IRS employees that supervisors consider tax enforcement results, such as additional dollars proposed per tax return and additional dollars proposed per hour of work, when preparing performance evaluations.⁵⁷ This point was well summarized by an IRS employee, who noted that “any successful revenue agent knows that low time and high dollars will result in recognition, promotion, and awards.”⁵⁸

Section *A* analyzes the strategic disadvantages of applying for an advance tax ruling, and section *B* considers the strategic advantages of applying for an advance tax ruling. Section *C* concludes by noting that in most cases the strategic disadvantages outweigh the strategic advantages.

A. Strategic Disadvantages of Applying for an Advance Tax Ruling

1. Increased Inspection

IRS audit rates across different types of tax returns are very low. The audit rate of tax returns filed by individuals increased from 0.49% in 2000 to 1.03% in 2007,⁵⁹ yet it remains low. Likewise, the audit rate of returns for business income was 0.19% in 2004,⁶⁰ and the audit rate of returns filed

Enforcement and Service Results: “The bottom line for our enforcement efforts shows that dollars collected rose again last year. There’s a strong trend line going up. Fiscal 2005 was a watershed year for us, with a number of big initiatives that helped push enforcement revenues up 10% to \$47.3 billion. In Fiscal 2006, enforcement revenues – the monies we get from our collection, examination, and document matching activities – increased to a record \$48.7 billion . . . our overall dollars collected jumped nearly 3% in 2006 principally because of a strong rise in collections.” Fiscal Year 2006 Enforcement and Service Results, <http://www.irs.gov/newsroom/article/0,,id=164435,00.html>.

⁵⁶ Internal Revenue Service Restructuring and Reform Act of 1998 §1204, 26 U.S.C. § 7804 note (“The Internal Revenue Service shall not use records of tax enforcement results (1) to evaluate employees; or (2) to impose or suggest production quotas or goals with respect to such employees.”). This policy was first adopted by the IRS in 1973 (IRS policy statement P-1-20, The Use of Enforcement Statistics (November 9, 1973)), and in 1988 it was included in the Taxpayer’s bill of rights (Taxpayer Bill of Rights, Pub. L. No. 100-647, § 6231 (Nov. 11, 1988)). The IRS Restructuring and Reform Act of 1998 repealed the taxpayer Bill of Rights prohibitions, covering only collection employees, and expanded the prohibitions to cover all employees.

⁵⁷ UNITED STATES GENERAL ACCOUNTING OFFICE, IRS PERSONNEL ADMINISTRATION: USE OF ENFORCEMENT STATISTICS IN EMPLOYEE EVALUATION 8-10, 28-33 (1998).

⁵⁸ *Id.*, at 40.

⁵⁹ Transactional Records Access Clearinghouse, Syracuse University, *Audits of Income Tax Returns Filed by Individuals* (<http://trac.syr.edu/tracirs/highlights/current/individual.html>).

⁶⁰ *Id.*, IRS Examination of Returns for Business Income and Other Taxpayers (<http://trac.syr.edu/tracirs/highlights/v10/business.html>).

by corporations dropped from 2.62% in 1997 to 1.24% in 2007.⁶¹ These low audit rates mean that the likelihood of having your tax return inspected by the IRS is extremely small.

When the taxpayer applies the favorable interpretation of the law and carries out the transactions without an advance tax ruling, his chosen interpretation might be rejected by the IRS. However, the probability of the IRS inspecting the taxpayer's tax return is less than 1%. By contrast, when the taxpayer applies for an advance ruling the IRS is guaranteed to inspect the transaction. In other words, by applying for an advance tax ruling the taxpayer increases the probability of inspection by the IRS from less than 1% to 100%.

This dramatic difference in the probability of inspection by the IRS is a strategic consideration taken into account by the taxpayers. It discourages taxpayers from applying for an advance tax ruling.

2. Increased Detection

Although audit rates for most tax returns are very low, for some tax returns they are relatively high. Large corporations in certain industries (Natural Resources and Construction; Heavy Manufacturing and Transportation; Retailers, Food, Healthcare and Pharmaceutical) had an audit rate of 100% in 2004.⁶² Large corporations in other industries (Communication, Technology and Media) had an audit rate of 84% in 2004.⁶³ Although these large corporations are a small fraction of the total number of corporations in the market, they control 90% of the assets held by corporations, and they earn 87% of income earned by corporations.⁶⁴ Thus, despite the relatively low audit rate of tax returns filed by individuals, the audit rate for large corporations, which control a great share of the economic activity, is relatively high. These corporations should not refrain from applying for an advance tax ruling due to increased inspection, since their audit rate is close to 100% even when they do not apply for an advance ruling.

Nevertheless, there is another factor that deters such corporations from applying for an advance tax ruling. It is the increased detection that results from applying for an advance tax ruling. In many cases of tax audits the auditors are unable to detect the controversial issues that arise in the tax

⁶¹ *Id.*, *IRS Face-to-Face Audits of Federal Income Tax Returns Filed by Corporations* (<http://trac.syr.edu/tracirs/highlights/current/corporations.html>).

⁶² *Id.*, *Audit Rates for Large Corporations with Assets of \$250 Million or More* (<http://trac.syr.edu/tracirs/highlights/v10/audindustry.html>).

⁶³ *Id.*

⁶⁴ *Id.*, *Corporation Assets and Income Relatively Few Corporations Have Most Income and Assets* (<http://trac.syr.edu/tracirs/highlights/v10/corpassets.html>).

return. Thus, even at an audit rate close to 100%, the taxpayer can expect that some of legally ambiguous tax issues will not be detected. By contrast, applying for an advance tax ruling on a legally ambiguous tax issue “red flags” this issue, and guarantees that the IRS will consider it.⁶⁵ The IRS’s increased attention may result in the exposure of adverse interpretations that would not have been exposed in a regular tax audit. In other words, even in cases where the probability of inspection by the IRS is 100% regardless of the taxpayer’s decision to apply for an advance tax ruling, by applying for an advance tax ruling the taxpayer significantly increases the probability of detection by the IRS.

The difference in the probability of detection by the IRS is a strategic consideration taken into account by the taxpayers, which discourages taxpayers from applying for an advance tax ruling.

3. Increased Expertise of Tax Examiners

If the taxpayer is a large corporation in an industry with very high audit rate, and the legally ambiguous tax issues is easily spotted, the IRS is guaranteed to detect the relevant legal issue regardless of whether the taxpayer applies for an advance tax ruling. Still, the taxpayer may refrain from applying for an advance tax ruling because of another factor – the level of expertise of the tax agent that will rule on the interpretation the law.

While tax audits are conducted by the examination division in one of the IRS’s district offices, advance tax rulings are issued by the IRS’s national office.⁶⁶ The agents in the main office usually have more expertise than the ones in the district offices. The level of expertise affects the likelihood of the agents making a mistake in their interpretation of the law.

Tax agents can make two types of mistakes in their interpretation of the law. The first type of mistake occurs when they rely on erroneous legal arguments to justify their adoption of the favorable interpretation of the law. The second type of mistake occurs when they rely on erroneous legal arguments to justify their adoption of the adverse interpretation of the law. The more expertise a tax agent has, the less likely he is to make a mistake of both types.

If the tax agent makes the first type of mistake the taxpayer will not correct him, since the taxpayer prefers the favorable interpretation to the adverse one. If the agent makes the second type of mistake the taxpayer can correct him by proving that the agent’s legal arguments are erroneous. The taxpayer may also appeal a mistake of the second type by requesting a

⁶⁵ Chang et. al., *supra* note 31, at 739 (mentioning the “possibility of tax savings through transactions that could escape the audit net”); Saltzman, *supra* note 50, at ¶3.03[3][b].

⁶⁶ 26 C.F.R. § 601.201(a)(1).

conference with the IRS Appeals Office.⁶⁷ Accordingly, more mistakes of the first type benefit the taxpayer, while more mistakes of the second type do not harm him, since they can be corrected. Consequently, the taxpayer prefers more mistakes of both types to fewer mistakes of both types.

Since the agents in the IRS's national main office have more expertise than the agents in the district offices, they are less likely to make mistakes of both types. Thus, the taxpayer would prefer the agents in the district office to rule on the interpretation of the law than the agents in the national office. This effect discourages taxpayers from applying for an advance tax ruling.

4. The Precedential Effect of Advance Tax Rulings

The precedential value of advance tax rulings was noted in the general report of the 1999 International Fiscal Association congress on Advance Ruling: “[I]n most countries advance rulings have some precedential value . . . even if this is only because a government in a modern democratic state cannot afford to act capriciously and unpredictably towards its taxpayers.”⁶⁸ This quote raises an important point. Even when advance tax rulings have no formal precedential value, they still might have a *de facto* precedential effect. What is the legal situation in the U.S. in this respect?

Until the mid-1970s, private letter rulings were not published or otherwise made available to the public.⁶⁹ In the mid-1970s, the IRS lost two freedom of information cases requesting disclosure of private letter rulings.⁷⁰ Following these decisions, section 6110 of the Internal Revenue Code was enacted, setting rules for the disclosure of private letter rulings. Accordingly, since 1977 the IRS has released private letter rulings on a weekly basis three months after they are issued, with any information that would serve to identify the requesting taxpayer deleted.⁷¹

Despite the publication of private letter rulings, their precedential value is formally limited. Section 6110(k)(3) of the Internal Revenue Code deals with the precedential status of private letter rulings and other written determinations. The section states that “a written determination may not be used or cited as precedent.”⁷² Thus, it seems that advance rulings have no precedential value.

Nevertheless, private letter rulings do have a precedential value, at least

⁶⁷ Meldman & Sideman, *supra* note 25, at 331.

⁶⁸ Ellis, *supra* note 33, at 25-26.

⁶⁹ Osteen et al., *supra* note 41, at 12-14.

⁷⁰ *Id.*; Tax Analysts and Advocates v. I.R.S., 505 F.2d 350 (D.C. Cir. 1974); Fruehauf Corp. v. I.R.S., 566 F.2d 574 (6th Cir. 1977).

⁷¹ Osteen et al., *supra* note 41, at 12-14.

⁷² 26 U.S.C. § 6110(k)(3).

to some extent. Their precedential effect is mainly due to their release to the public domain, and the IRS's duty of consistency toward similarly situated taxpayers.⁷³ This point is emphasized by Saltzman:

[T]he Service generally cannot treat similarly situated taxpayers differently, especially when it results in granting the taxpayer receiving the initial ruling an economic or competitive advantage over the other taxpayer. Accordingly, when the result of denying the tax treatment specified in the ruling to another taxpayer (who requested a similar ruling) would be to apply the internal revenue laws in favor of the taxpayer who received the first ruling to the disadvantage of the other taxpayer, the Service may be required to issue the same ruling to both taxpayers.⁷⁴

The use of private letter rulings as precedents following their disclosure, spurred a debate among scholars and practitioners.⁷⁵ Notwithstanding this debate, it is clear that private letter rulings have a precedential value in practice. They can be easily obtained from both Lexis and Westlaw, and are often cited in lawyers' briefs. Furthermore, courts often cite private letter rulings in support of a position or as proof of past Service position. The Supreme Court in *Hanover Bank v. Commissioner* noted that "although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."⁷⁶ Other courts have also relied on private letter rulings for similar purposes.⁷⁷ The actual treatment

⁷³ This duty was stated by Justice Frankfurter in *United States v. Kaiser*, 363 US 299, 308 (1960) ("The Commissioner cannot tax one and not tax another without some rational basis for the difference"). See also *Sirbo Holdings, Inc. v. Commissioner*, 476 F.2d 981, 987 (2d. Cir. 1973); Saltzman, *supra* note 50, at ¶3.03[6][b]; Lawrence Zelenak, *Should Courts Require the Internal Revenue Service to be Consistent?*, 40 TAX L. REV. 411 (1985).

⁷⁴ Saltzman, *supra* note 50, at ¶3.03[6][b].

⁷⁵ See Gerald G. Portney, *Letter Rulings: An Endangered Species?*, 36 TAX LAWYER 751 (1983); James P. Holden & Michael S. Novey, *Legitimate Uses of Letter Rulings Issued to Other Taxpayers - A Reply to Gerald Portney*, 37 TAX LAWYER 337 (1984); Zelenak, *supra* note 73. For a more recent article on the subject see Christopher M. Pietruszkiewicz, *Does the Internal Revenue Service Have a Duty to Treat Similarly Situated Taxpayers Similarly?*, 74 U. CIN. L. REV. 531 (2005).

⁷⁶ *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962). The Supreme Court then quotes from a private letter ruling to support the petitioner's understanding of the tax law. Note that this decision was issued before private letter rulings were routinely disclosed.

⁷⁷ For example, in *Wolpaw v. Commissioner* (47 F.3d 787, 792 (6th Cir. 1995)), the

of private letter rulings as precedents by many courts is well summarized in a practitioners' guide, stating that "both taxpayers and courts have often disregarded § 6110(k)(3) in whole or in part and have given precedential value to written determinations."⁷⁸

According to the above analysis, while a favorable decision by the IRS in an audit has no precedential value, since it is simply a decision to approve to taxpayer's tax return and it remains unknown to the public, a favorable advance tax ruling has a *de facto* precedential effect. The difference between the precedential effect of a tax audit and an advance tax ruling may affect the IRS's decision. If a favorable interpretation of an ambiguous law is expected to decrease future tax revenue, the IRS will be more reluctant to adopt such an interpretation in an advance tax ruling than in a tax audit, since a favorable advance tax ruling has a precedential effect, while a similar interpretation in a tax audit has no precedential effect.

Since the IRS is more reluctant to adopt a favorable interpretation of the law in an advance ruling than in a tax audit, the taxpayer will be more reluctant to apply for an advance tax ruling. In other words, the *de facto* precedential effect of advance tax rulings discourages taxpayers from applying for an advance tax ruling.

5. The Commitment in Carrying Out the Transaction

Generally speaking, courts are influenced by the specific facts of each case. More accurately, this means that different sets of facts may raise the same legal question, and the court's decision on this legal question is affected by the set of facts that was brought before it.

In our case there is legal ambiguity concerning the amount of tax that has to be paid on a certain transaction. Suppose that this transaction could

Sixth Circuit court cites a relevant private letter ruling, contrary to the Tax Court's reasoning, and claims that in the absence of regulations directly on point, a private letter ruling may be viewed as evidence of the IRS's treatment of tuition remissions. *See also* Judy S. Kwok, *The Perils of Bright Lines: Section 6110(k)(3) and the Ambiguous Precedential Status of Written Determinations*, 24 VA. TAX REV. 863, 877-884 (2005) (surveying decisions by different courts that use private letter rulings and other written determinations to support the taxpayer's position against the IRS or vice versa, or as revealing past IRS positions or interpretations of statutes). *But see id.*, at 873-877 (surveying decisions where the court refused to use or cite private letter rulings and other written determinations for any purpose).

⁷⁸ LISA M. STARCZEWSKI, 621-2ND TAX MANAGEMENT, IRS NATIONAL OFFICE PROCEDURES - RULINGS, CLOSING AGREEMENTS, A-42 (2002, updated through 2006); Kwok, *id.*, at 873. *See also* Chang et. al., *supra* note 31, at 740 ("Notwithstanding IRC section 6610(j)(3), in practice, private letter rulings are widely read and relied upon in tax planning."); Lainoff, *supra* note 45, at 36 ("[I]t is increasingly common for taxpayers, in proceedings before the Service or the courts, to use advance rulings issued to other taxpayers as evidence of the Service's position on similar transactions.")

be structured in different ways, and the transaction's structure affects the court's decision on this legal issue. As noted before, one of the IRS's considerations when deciding how to interpret an ambiguous law is the effect of its decision on tax revenue. Accordingly, if the transaction is structured in a way that is relatively favorable to the taxpayer, the IRS may be reluctant to take it to court, since the court's ruling is a precedent, and therefore a favorable ruling by the court will have a negative effect on future tax revenue. In such a case the IRS would rather wait for a similar transaction that is structured in a way that is not as favorable to the taxpayer, and take that transaction to court.

The effect of the structure of the transaction on the IRS's willingness to go to court introduces another strategic consideration – a commitment. Commitment is a counterintuitive concept, defined by Nobel laureate Thomas Schelling as:

[B]ecoming committed, bound, or obligated to some course of action or inaction or to some constraint on future action. It is relinquishing some options, eliminating some choices, surrendering some control over one's future behavior. And it is doing so deliberately, with a purpose. The purpose is to influence someone else's choices. Commitment does so by affecting that other's expectation of the committed one's behavior.⁷⁹

The concept of commitment means that, counterintuitively, it is sometimes better to limit your choices, since this might deter an opponent.⁸⁰ In our case, when the taxpayer carries out the transaction without applying first for an advance tax ruling he relinquishes the option to forgo the transaction following an adverse ruling by the IRS. Although maintaining the option to forgo the transaction may seem one of the advantages of applying for an advance tax ruling, there are cases where, counterintuitively, it is better to relinquish this option. This point is clarified

⁷⁹ THOMAS C. SCHELLING, *STRATEGIES OF COMMITMENT* 1 (2006). *See also* THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* 21-52 (2d. ed. 1980).

⁸⁰ A simple example can illustrate this point. Suppose country A and country B wish to occupy an Island that is located between the countries, and connected by a bridge to both. Suppose also that each country prefers to let its opponent have the island to fighting. If country A's army occupies the island and burns the bridge behind it, country B has no option but to let country A have the Island. Country B knows that if it sends its army to the Island, country A's army will have no choice other than to fight back, so it prefers to let country A have the island to fighting. In this example, country A does better than country B although it reduced its set of choices by burning the bridge and eliminating the option of withdrawing its army from the island. JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 316 (1988).

by the following example.

Suppose a taxpayer considers a transaction with a net economic revenue before taxes of \$100,000.⁸¹ The amount of tax that will be levied upon the transaction is uncertain. There are two possible tax levels, \$20,000 and \$80,000. The expected tax that will be ruled by the court is \$68,000 (i.e. there is a probability of 0.8 that the court will rule that \$80,000 should be paid, and accordingly a 0.2 probability that the court will rule that \$20,000 should be paid). Suppose also that the taxpayer may carry out an alternative transaction with an after tax profit of \$40,000.

If the taxpayer applies for an advance tax ruling and the IRS rules that \$80,000 should be paid as tax, the taxpayer will forgo the contemplated transaction. Since the taxpayer's expected profit from carrying out the transaction and appealing the ruling is \$32,000 ($= \$100,000 - \$68,000$), he would rather forgo the transaction and carry out the alternative transaction with a profit of \$40,000.

By contrast, if the taxpayer carries out the transaction without an advance tax ruling, and the IRS decides when auditing his tax return that \$80,000 should have been paid as tax, the taxpayer will appeal the ruling. If he appeals the ruling his expected profit is \$32,000 ($= \$100,000 - \$68,000$), while if he does not appeal the ruling his profit is \$20,000 ($= \$100,000 - \$80,000$). Because the taxpayer cannot undo the transaction that was already carried out, appealing the ruling in this case is preferable.

The example shows that there are cases where the taxpayer does not appeal an adverse advance ruling, but appeals a similar decision in an audit. If the transaction is structured in a way that is favorable to the taxpayer then, as noted before, the IRS will be reluctant to take it to court. In such a case, carrying out the transaction without an advance ruling will result in the IRS adopting a favorable interpretation in the tax audit, while applying for an advance tax ruling will result in an adverse ruling. The reason is that, as was shown in the example, the IRS knows that an adverse advance ruling will not be appealed, and thus such a ruling will not lead to a precedential ruling by the court with a negative effect on future tax revenue. By contrast, as was shown in the example, an adverse decision in the tax audit will be appealed, and will result in a precedential ruling by the court that will decrease future tax revenue.

By carrying out the transaction the taxpayer relinquishes the option to forgo the transaction following an adverse ruling, and commits to appealing an adverse decision in the tax audit. If the IRS is reluctant to take the case to

⁸¹ This net economic revenue incorporates all economic expenses that have to do with the transaction, excluding taxes.

court this commitment guarantees a favorable interpretation in the tax audit. This effect decreases the incentive to apply for an advance tax ruling.

B. Strategic Advantages of Applying for an Advance Tax Ruling

1. Avoiding Penalties

If the taxpayer applies the favorable interpretation of the law and carries out the transaction, and in the tax audit the IRS adopts the adverse interpretation, the IRS may not only require the taxpayer to comply with its interpretation of the law, but may also penalize him. By contrast, if the taxpayer applies for an advance tax ruling and the IRS issues an adverse ruling, the taxpayer can either forgo the transaction or comply with the IRS's position, with no risk of a penalty. Thus, applying for an advance tax ruling eliminates the risk of a penalty. This is an incentive for the taxpayer to apply for an advance tax ruling,

Notwithstanding the above analysis, it seems that when several interpretations of the law are possible, applying the favorable interpretation will rarely expose the taxpayer to a real risk of penalty, whether criminal or civil.

Criminal tax penalties are imposed only in extreme cases. The criminal offense of tax evasion requires the taxpayer to "willfully" evade tax.⁸² This was interpreted to mean "a voluntary, intentional violation of a known legal duty".⁸³ Accordingly, the IRS has to prove "that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty."⁸⁴ Where tax law is uncertain or debatable and the taxpayer adopts an interpretation that is different than the IRS's, the taxpayer lacks the requisite intent for a criminal penalty.⁸⁵ Consequently, in such cases carrying out the transaction without an advance ruling does not expose the taxpayer to a risk of a criminal penalty.

Although civil penalties can be imposed in more cases than criminal penalties, applying a favorable interpretation of the law when several interpretations are possible will rarely allow the IRS to impose a civil penalty. The two civil penalties that are relevant to our case are the fraud penalty and the accuracy related penalty.

The civil fraud penalty imposes a penalty of 75% of the underpayment for underpayments which are attributable to fraud.⁸⁶ In tax court proceedings that involve the fraud penalty, the IRS has to prove that the

⁸² 26 U.S.C. § 7201.

⁸³ *United States v. Pomponio*, 429 U.S. 10, 12 (1976).

⁸⁴ *Cheek v. United States*, 498 U.S. 192, 201 (1991).

⁸⁵ Saltzman, *supra* note 50, at ¶7A.07[1].

⁸⁶ 26 U.S.C. § 6663(a). *See also* *Iley v. Commissioner*, 19 T.C. 631, 635 (1952).

taxpayer is guilty of “fraud with intent to evade tax”.⁸⁷ This was interpreted not to include negligence, but rather “actual, intentional wrongdoing . . . [with] the specific purpose to evade a tax believed to be owing.”⁸⁸ Thus, a mistake of law is not considered fraud with intent to evade tax.⁸⁹ Consequently, when several interpretations of the law are possible, applying the favorable interpretation and carrying out the transaction without an advance ruling does not constitute an act of fraud.

The accuracy related penalty imposes a 20% penalty on certain underpayments, where the two types of underpayments that are relevant to our case are underpayments due to negligence or disregard of rules or regulations, or substantial understatement of income tax.⁹⁰ Let us begin with the accuracy related penalty for underpayments due to negligence or disregard of rules or regulations. Negligence includes failure to make a reasonable attempt to comply with the tax provisions.⁹¹ A return position that has a “reasonable basis” is not attributable to negligence,⁹² but the definition of a “reasonable basis” is unclear.⁹³ However, it is clear that a return position has “reasonable basis” even if the likelihood of it being upheld is significantly less than 50%.⁹⁴ Moreover, a taxpayer will not be liable for negligence if the underpayment resulted from “a mistake of law or fact made in good faith and on reasonable ground.”⁹⁵ Thus, a return position

⁸⁷ 26 U.S.C. § 7454(a).

⁸⁸ *Mitchell v. Commissioner*, 118 F.2d 308, 310 (1941). *See also* Saltzman, *supra* note 50, at ¶7B.02[3].

⁸⁹ *Welburn Mayock v. Commissioner*, 32 TC 966, 974 (1959).

⁹⁰ 26 U.S.C. § 6662.

⁹¹ 26 U.S.C. § 6662(c).

⁹² 26 C.F.R. 1.6662-3(b)(1)

⁹³ “Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.” 26 C.F.R. § 1.6662-3(b)(3).

⁹⁴ “[T]he return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.” 26 C.F.R. § 1.6662-3(b)(3). The substantial authority standard is “an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50% likelihood of the position being upheld), but more stringent than the reasonable basis standard”. 26 C.F.R. § 1.6662-4(d)(2). Thus, a return position can be considered to have substantial authority even when the likelihood of it being upheld is less than 50%. Since a return position has reasonable basis even if it is not considered to have substantial authority, this means that a return position may have reasonable basis even if the likelihood of it being upheld is significantly less than 50%.

⁹⁵ *Saltzman*, *supra* note 50, at ¶7B.03[2][b][ii]. *See also* *Scott v. Commissioner*, 61 T.C. 654, 663 (1974) (“[A] clearly a bona fide dispute which presents substantial issues of law and fact and which consequently prevents any imposition of an addition to tax.”)

applying a favorable interpretation of the law when several interpretations are possible will not be considered negligent, as long as the probability of it being upheld is reasonable.

Now, let us turn to the accuracy related penalty for substantial understatement of income tax. An understatement of income tax is considered substantial if the income tax required to be shown on the tax return is greater than the income tax actually reported by the taxpayer by \$5,000 or 10% of the required amount.⁹⁶ As one can see, the threshold for a substantial understatement of income tax is relatively low. However, an understatement of income tax due to a tax treatment with a “substantial authority” will not be included in the understatement.⁹⁷ The definition of a “substantial authority” is vague,⁹⁸ but a tax treatment has “substantial authority” even if the likelihood of it being upheld is less than 50%.⁹⁹ If the taxpayer adequately discloses the relevant facts affecting the item’s tax treatment, it is enough for the position to have “reasonable basis” only,¹⁰⁰ and as noted before this means that the likelihood of the position being upheld can be significantly less than 50%.¹⁰¹ Accordingly, when several interpretations of law are possible, there will be many cases where a substantial understatement of income tax will not result in a penalty.

Both civil penalties, the fraud penalty and the accuracy related penalty, cannot be imposed if the taxpayer can show reasonable cause and good faith.¹⁰² What determines reasonable cause and good faith is not always clear, but an honest misunderstanding of fact or law may indicate reasonable cause and good faith.¹⁰³ Furthermore, it has been determined that “[w]hen an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice.”¹⁰⁴ Thus, when applying a favorable interpretation of the law, it appears that even when the conditions for imposing the civil penalties are met, the reasonable cause and good faith exception will apply in many cases and prevent the IRS from imposing the penalty.

Based on the above analysis, it seems that when several interpretations of law are possible, only in rare cases will the taxpayer be exposed to a real

⁹⁶ 26 U.S.C. § 6662(d).

⁹⁷ 26 U.S.C. § 6662(d)(2)(B).

⁹⁸ 26 C.F.R. § 1.6662-4(d)(2).

⁹⁹ See note 94.

¹⁰⁰ 26 U.S.C. § 6662(d)(2)(B)(ii).

¹⁰¹ See note 94.

¹⁰² 26 U.S.C. § 6664(c).

¹⁰³ 26 C.F.R. § 1.6664-4(b)(1).

¹⁰⁴ *United States v. Boyle*, 469 US 241, 251 (1985). The court analyzed the “reasonable cause” exception for the penalty that is imposed in case of failure to file a return on the date it is due.

risk of a penalty when applying a favorable interpretation of the law.¹⁰⁵ Thus, avoiding penalties is not a significant consideration for the taxpayer to apply for an advance tax ruling.

2. The Threat in Applying for an Advance Ruling

When the taxpayer applies for an advance tax ruling he makes a threat. The threat is that if an adverse ruling is issued he will forgo the transaction and carry out an alternative transaction, and consequently the IRS might collect less tax.

Let us further explain this threat. As noted before, one of the IRS's considerations when deciding on its interpretation of an ambiguous law is the effect of its decision on tax revenue. Suppose the IRS knows that given a favorable interpretation of the law, more tax will be collected from the original transaction than from an alternative one, but the maximum amount of tax will be collected if the original transaction is carried out and the adverse interpretation is applied. The IRS also knows that the taxpayer's profit from the alternative transaction is greater than his profit from the original one, given an adverse interpretation of the law.

In such a case by applying for an advance tax ruling the taxpayer guarantees a favorable interpretation. When the IRS rules on the advance tax ruling, it knows that an adverse ruling will result in less tax being collected, since following such a ruling the taxpayer will forgo the original transaction and instead carry out the alternative one. By contrast, if the taxpayer carries out the original transaction without applying first for an advance tax ruling, the IRS will adopt an adverse interpretation of the law in the tax audit. Since the transaction was carried out the IRS knows that adopting the adverse interpretation of the law will lead to a higher collection of tax, because the taxpayer is unable at that stage to undo the transaction and carry out the alternative one.

The threat of carrying out the alternative transaction following an adverse ruling is an incentive for the taxpayer to apply for an advance tax ruling. However, this effect is limited to cases where the IRS expects to collect less tax from the alternative transaction than from the original one.

¹⁰⁵ In certain types of transactions applying the law in a wrong manner could have severe consequences. For example, a spin-off that fails to qualify as a tax free spin-off (26 U.S.C. § 355) triggers dividend income to shareholders and taxable gain to the distributing company. It may also result in the shareholders suing the management of the company for negligent behavior. Similarly, if a transaction by a private foundation is considered an act of self-dealing, or if an investment by private foundation is considered an investment that jeopardizes the private foundation's exempt purposes, a tax is imposed on the foundation manager (26 U.S.C. §§ 4941, 4943). In these types of transactions an advance ruling will be requested before the transaction is carried out. Indeed, in 2007 the IRS issued 123 rulings on tax free spin-offs and transactions by private foundations.

C. *Weighing the Strategic Considerations*

This part analyzed the taxpayer's strategic considerations when deciding whether to apply for an advance tax ruling. Although two strategic advantages of applying for an advance tax ruling were noted – a threat that can lead in some cases to a favorable interpretation, and to a much lesser extent the avoidance of penalties – the strategic disadvantages outweigh the strategic advantages in most cases.

For taxpayers with a very low expected audit rate, applying for an advance tax increases the IRS's probability of inspection to 100%. For large corporations with a very high expected audit rate, applying for an advance ruling increases the IRS's detection rate by "red flagging" the questionable legal issues. Moreover, even when the questionable legal issue is easily detected, applying for an advance tax ruling means that tax agents with greater expertise will rule on this issue. Additionally, because of the *de facto* precedential effect of advance tax rulings, the IRS will be reluctant to issue a favorable advance ruling. The commitment in carrying out the transaction is another reason not to apply for an advance ruling. These considerations seem to offer an explanation for the surprisingly infrequent use of the advance tax ruling procedure in US.

V. IMPLICATIONS FOR ADVANCE PRICING AGREEMENTS

A. *Transfer Pricing - Overview*

Transfer pricing is a way of shifting taxable income from a company that is located in a high-tax jurisdiction to another company that belongs to the same organization but is located in a low-tax jurisdiction. This is done by strategically setting the transfer prices of international transactions between related companies.¹⁰⁶

Transfer pricing is probably the most significant problem in modern international taxation.¹⁰⁷ Multinational companies identify transfer pricing as the "most important tax issue they face", and most multinational

¹⁰⁶ MYRON S. SCHOLES ET AL., *TAXES AND BUSINESS STRATEGY* 326 (3d. ed. 2005); Hubert Hamaekers, *Introduction to Transfer Pricing*, in *THE TAX TREATMENT OF TRANSFER PRICING* 1, 10 (Hubert Hamaekers, Maurice H. Collins & Wilhelmina A. Comello eds., 2006). Determining the prices of goods and services transferred among segments of the same organization is also important for evaluating the performance of each of the organization's units. See ROGER Y.W. TANG, *TRANSFER PRICING IN THE 1990S* 1 (1993); Hamaekers, *supra*, at 9. However, the tax benefits of transfer pricing are usually far greater than the benefits derived from a more accurate evaluation of the performance of the organization's units.

¹⁰⁷ See note 6.

companies believe that transfer pricing will be “absolutely critical” or “very important” to them in the coming years.¹⁰⁸ Likewise, tax authorities around the world place the transfer pricing problem high on their agendas.¹⁰⁹

The effect of each transfer pricing manipulation on U.S. tax revenue is frequently of great significance. In 1994 the IRS proposed 64 adjustments of income of more than \$20 million due to transfer pricing, with an aggregate amount of \$3.5 billion.¹¹⁰ A recent tax dispute on transfer pricing between the U.S. and the U.K. by the leading pharmaceutical company GlaxoSmithKline was settled for \$3.4 billion, the largest single payment the IRS has ever negotiated in a tax dispute.¹¹¹

The principle of arm’s length pricing, according to which prices of international transactions between related companies should be set equal to prices of similar transactions between two comparable independent companies, is used to prevent a reduction of tax payments through transfer pricing. Section 482 of the Internal Revenue Code allows the IRS to allocate income between two associated organizations if it is “necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.”¹¹² According to section 482 regulations, the principle guiding such allocation is the arm’s length principle.¹¹³

¹⁰⁸ ERNST & YOUNG, 2007-2008 GLOBAL TRANSFER PRICING SURVEY 9-10 (December 2007) [hereinafter TRANSFER PRICING SURVEY].

¹⁰⁹ ERNST & YOUNG, 2005-2006 GLOBAL TRANSFER PRICING SURVEY - TAX AUTHORITIES INTERVIEWS 7 (September 2005).

¹¹⁰ UNITED STATES GENERAL ACCOUNTING OFFICE, INTERNATIONAL TAXATION: TRANSFER PRICING AND INFORMATION ON NONPAYMENT OF TAX 19 (, 1995) [hereinafter GAO TRANSFER PRICING REPORT]. In 1990 the IRS made 37 adjustments of more than \$20 million due to transfer pricing, totaling \$6 billion. *Id.* Although not all proposed adjustments result in increased tax collection, since taxpayers may have offsetting losses, or may challenge the proposed adjustments, these amounts illustrate the significance of the transfer pricing problem. In fact, these figures are a low estimate of the problem’s magnitude, since many transfer pricing manipulations are not detected by the IRS.

¹¹¹ Nutt, *supra* note 10. The dispute involved tax claims of \$4.6 billion.

¹¹² 26 U.S.C. § 482.

¹¹³ 26 C.F.R. § 1.482-1(b)(1) (“In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. A controlled transaction meets the arm’s length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm’s length result).”); *see also* UNITED STATES MODEL INCOME TAX CONVENTION, Art. 9 (November 15, 2006). The arm’s length principle has also been adopted by the OECD countries. TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS I-1 - I-28 (Organization for Economic Cooperation and Development, 2001) [hereinafter TRANSFER PRICING GUIDELINES]; MODEL CONVENTION WITH RESPECT TO TAXES ON INCOME AND CAPITAL, Art. 9 (Organization for Economic Cooperation and Development, July 15, 2005).

The arm's length principle, although theoretically adequate for preventing manipulative use of transfer pricing,¹¹⁴ is in fact difficult to employ. In many cases it is difficult to identify comparable transactions, and no single "correct" transfer price can be determined.¹¹⁵ Thus, applying the arm's length principle involves inherent legal uncertainty.

The consequences of uncertainties concerning the arm's length price are exacerbated by the nature of the transfer pricing problem, which involves the tax authorities of more than one country. Disagreements between tax authorities of different countries on the implementation of the arm's length principle to a certain set of facts could result in double taxation.¹¹⁶ It is due to these problems that a procedure for obtaining advance pricing agreements was introduced.¹¹⁷

B. Advance Pricing Agreements

An advance pricing agreement (sometimes referred to as an APA) is an agreement between the tax authorities and a taxpayer regarding the appropriate transfer pricing method that will be used for pricing future inter-company international transactions. The taxpayer discloses to the tax authorities details of his business operations and other relevant information, and submits a proposed transfer pricing methodology. After negotiations, the taxpayer and the tax authorities conclude a binding agreement according to which the taxpayer's transfer pricing cannot be challenged by the IRS for several years, as long as he adheres to the agreement.¹¹⁸

The advance pricing program was introduced in the U.S. by the IRS in 1991,¹¹⁹ and the most up-to-date guidance on advance pricing agreements was issued in 2006.¹²⁰ The advance pricing program in the U.S. has been

¹¹⁴ But see Scholes et al., *supra* note 106, at 326 (noting that "circumstances under which the related parties find it desirable to integrate vertically are systematically different from those in which transactions take place at arm's length in the market"); see also Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (Feb. 17, 1986).

¹¹⁵ Reuven S. Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301, 1342 (1996).

¹¹⁶ Ring, *supra* note 8, at 155.

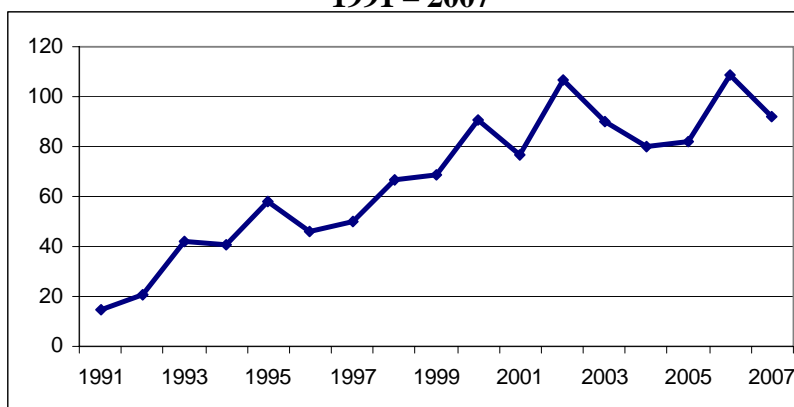
¹¹⁷ See Tillinghast, *supra* note 8, at 43 ("In an effort to ease the enormous administrative burden of policing cross-border transfer pricing, the IRS has created the advance-pricing agreement (APA) procedure."); see also Avi-Yonah, *supra* note 6, at 154-156.

¹¹⁸ Scholes et al., *supra* note 106, at 327; see also TRANSFER PRICING GUIDELINES, *supra* note 113, at IV-41; Rev. Proc. 2006-9, 2006-2 I.R.B. 278, § 1.04.

¹¹⁹ Rev. Proc. 91-22, 1991-11 I.R.B. 11.

¹²⁰ Rev. Proc. 2006-9, *supra* note 118. The procedure for obtaining an advance pricing agreement was updated first in 1996 (Rev. Proc. 96-53, 1996-49 I.R.B. 9), and again in 2004 (Rev. Proc. 2004-40, 2004-29 I.R.B. 50).

**Figure 5: Applications for Advance Pricing Agreements
1991 – 2007**



Source: Internal Revenue Service, Annual Report Concerning Advance Pricing Agreements (April 5, 2000); Internal Revenue Service, Announcement and Report Concerning Advance Pricing Agreements 2001 through Announcement and Report Concerning Advance Pricing Agreements 2008; Applications filed during 1991 through 1995 are reflected on a September 30 fiscal year-end basis. The number of applications filed from October 1 to December 31, 1995 is 23, and they are included in the total of 58 applications filed in 1995. Applications filed in 1996 through 1999 are reflected on a calendar year-end basis.

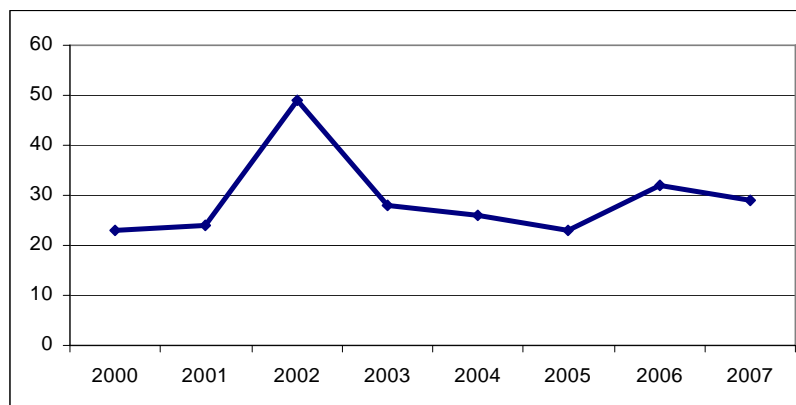
described in several publications.¹²¹ Figure 5 presents the number of applications for advance pricing agreements in the U.S. between 1991 and 2007.

Not all executed pricing agreements are in fact *advance* pricing agreements. Some executed agreements are rollback agreements, where the agreement is used to resolve transfer pricing disputes in prior years. Other executed agreements are renewals of previous agreements. Figure 6 presents the number of *new* advance pricing agreements concerning *future* inter-company international transactions that were executed in the U.S. between 2000 and 2007.

As one can see from figures 5 and 6, despite the significant benefits of advance pricing agreements in reducing uncertainty, preventing double taxation, and avoiding penalties, they are not widely used. Although the number of applications for advance pricing agreements has been rising in recent years, as shown in figure 5, it seems relatively small compared to the actual number of transfer pricing cases. To illustrate, in 2002 the 7,500 largest foreign corporations controlled by U.S. corporations had \$5.8 trillion

¹²¹ Ring, *supra* note 8, at 163-68; Ackerman et al., *supra* note 8; Triplett & Trauman, *supra* note 50, at 61-80; Robert Culbertson & Christine Halphen, *supra* note 43.

**Figure 6: New Future Advance Pricing Agreements Executed
2000 – 2007**



Source: Internal Revenue Service, Announcement and Report Concerning Advance Pricing Agreements 2001 through Announcement and Report Concerning Advance Pricing Agreements 2008; Total executed advance pricing agreements less renewals executed and rollbacks executed.

in assets and reported receipts of \$2.3 trillion.¹²² These figures do not include many more smaller foreign corporations controlled by U.S. corporations, and U.S. corporations controlled by foreign corporations. All these corporations are involved in thousands of transfer pricing cases every year.

What explains the infrequent use of advance pricing agreements? The waiting period for completing an advance pricing agreement is very long – the median waiting period in 2006 was 28 months.¹²³ Moreover, requesting an advance pricing agreement is costly. The application fee for an advance pricing agreement is \$50,000,¹²⁴ and in addition significant payments have to be made to lawyers and economists. However, most of these expenses have to be borne regardless of whether an advance pricing agreement is sought, since the taxpayer has to obtain professional advice in order to set the transfer prices in accordance with the law, and in order to meet the requirement for the existence of detailed documentation establishing the reasonableness of the pricing method that is used.¹²⁵ Additionally, there is a

¹²² Mike Masters and Catterson Oh, *Controlled Foreign Corporations, 2002* (<http://www.irs.gov/pub/irs-soi/02cfcart.pdf>).

¹²³ Ruchard McAlonan, Kerwin Chung & Darrin Litsky, *Annual Report Provides Transparency into APA Process*, 115 TAX NOTES 1283 (June 25, 2007).

¹²⁴ Rev. Proc. 2006-9, *supra* note 118, § 4.12(3).

¹²⁵ 26 U.S.C. § 6662(e)(3)(B). The documentation has to be in existence as of the time of filing the tax return.

lower application fee for small businesses.¹²⁶

Notwithstanding the aforementioned explanations, it seems that the infrequent use of advance pricing agreements is also explained by the same strategic considerations that explain the infrequent use of advance tax rulings.

Given the fact intensive nature of transfer pricing audits, they are expensive to conduct.¹²⁷ Therefore, the probability of the IRS inspecting the taxpayer's transfer pricing method is relatively low, and by requesting an advance pricing agreement the taxpayer guarantees that his transfer pricing will be inspected. Still, a recent survey showed that many corporations think the IRS is "fairly likely" or "very likely" inspect their transfer pricing method in the next two years.¹²⁸ Nevertheless, even those corporations may refrain from requesting an advance pricing agreement, since in order to obtain an agreement they need to disclose details of their business operations, thus "red flagging" ambiguous tax issues to be considered by the IRS. These tax issues may remain undetected in a regular audit. Furthermore, applying for an advance pricing agreement means that the taxpayer's transfer pricing method will be examined by the APA office,¹²⁹ with expert agents who are less likely to make mistakes than regular auditors in the IRS's district offices.¹³⁰

Since advance pricing agreements are not disclosed to the public,¹³¹

¹²⁶ The fee is \$22,500. The lower fee applies if the taxpayer has a gross income of less than \$200 million, or the aggregate value of the covered transactions does not exceed \$50 million annually, or \$10 million annually with respect to transactions involving intangible property. *Id.* § 4.12(5).

¹²⁷ In 1993, 35% of the IRS's international examiners time and 59% of the IRS's economist time was spent on cases involving section 482 issues. GAO TRANSFER PRICING REPORT, *supra* note 110, at 22.

¹²⁸ TRANSFER PRICING SURVEY, *supra* note 108, at 46.

¹²⁹ This office is within the Office of the Associate Chief Counsel (International). Rev. Proc. 2006-9, *supra* note 118, § 1.06.

¹³⁰ The agents at the APA office undergo special training activities. Moreover, in 2005 the IRS Chief Counsel decided to increase specialization within the APA office by creating teams of select individuals to handle all cases of a particular type. INTERNAL REVENUE SERVICE, ANNOUNCEMENT AND REPORT CONCERNING ADVANCE PRICING AGREEMENTS 7-9 (March 27, 2008).

¹³¹ They are considered return information, which cannot be disclosed. 26 U.S.C. § 6103(b)(2)(c) (referring to "any advance pricing agreement entered into by a taxpayer and the Secretary and any background information related to such agreement or any application for an advance pricing agreement"). This definition was added in 1999, after the IRS indicated (following a disclosure lawsuit) that advance pricing agreements constitute written determinations subject to redacted disclosure under section 6110 of the Internal Revenue Code. See Barton Massey, *Shielding Advance Pricing Agreements: Was There Fair Debate of Policy Concerns?*, 19 TAX NOTES INT'L 2389, 2389 (Dec. 27, 1999); Ring, *supra* note 8, at 167-68.

they have no *de facto* precedential effect that will deter the IRS from adopting a favorable position. However, the commitment effect still plays a role in encouraging the taxpayer to forgo an advance pricing agreement and commit to appealing an adverse interpretation in the tax audit, when the IRS is reluctant to take a certain case to court.

The strategic advantages of requesting an advance pricing agreement are relatively weak. The taxpayer will rarely decide to request an advance pricing agreement in order to avoid penalties, since penalties are not imposed very often.¹³² The strategic threat that the taxpayer will forgo his activity and carry out an alternative activity is effective only if the IRS expects to collect less tax from the alternative activity. But in transfer pricing cases this is rarely the case.

Since the strategic disadvantages of requesting an advance pricing agreement usually outweigh the strategic advantages of requesting such an agreement, this analysis could explain the infrequent use of advance pricing agreements. Moreover, based on this analysis one should not expect to see a significant growth in the number of applications for advance pricing agreements in coming years, even if efforts are made to expedite the process.¹³³ This also means that the introduction of advance pricing agreements does not signal the end of the transfer pricing problem.

CONCLUSION

Why are advance tax rulings infrequently used, when they seem to offer a solution to the uncertainty of tax law? This article analyzes the taxpayer's strategic considerations when deciding whether to request an advance tax ruling, thus attempting to offer an explanation to this puzzle. This analysis has important implications not only for our understanding of advance tax rulings, but also for our understanding of advance pricing agreements – a similar procedure that was introduced in recent years.

More broadly, the article presents a strategic analysis of the interaction between taxpayers and the IRS. This type of analysis could be applied to other cases, resulting in new insights for the analysis of tax law enforcement by the IRS.

¹³² A recent study found that in audit cases resulting in adjustments, US tax authorities imposed penalties in 12% of cases. TRANSFER PRICING SURVEY, *supra* note 108, at 14, 46.

¹³³ This is contrary to the common view, according to which “If there is anything that frustrates taxpayers about the APA program and makes them reluctant to pursue an APA, it is that the process simply takes too long.” McAlonan et al., *supra* note 123.