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ARTICLES

CONGRESSIONAL INSIDER TRADING RUNS DEEP: WILL THE STOCK ACT ONLY SKIM THE SURFACE?
Gwen Seaquist, Alka Bramhandkar & Marlene Barken …………………. ..…………..……………....1

INTERNATIONAL TAX LAW: TRANSFER PRICING FOR ASSETS, GOODS AND SERVICES
Richard J. Kraus & Roy J. Girasa……..……..........21

DETERMINING WHETHER AN ACTIVITY IS A TRADE OR BUSINESS
Martin H. Zern...……………………..………..…39

FOREIGN DIRECT INVESTMENT AND GLOBAL LEGAL STRUCTURES
John Paul..……………………………….……….70

CONGRESSIONAL INSIDER TRADING RUNS DEEP – WILL THE STOCK ACT ONLY SKIM THE SURFACE?

by
Gwen Seaquist*
Alka Bramhandkar**
Marlene Barken***

A scorpion and a frog meet on the bank of a stream and the scorpion asks the frog to carry him across on its back. The frog asks, "How do I know you won't sting me?" The scorpion says, "Because if I do, I will die too." The frog is satisfied, and they set out, but in midstream, the scorpion stings the frog. The frog feels the onset of paralysis and starts to sink, knowing they both will drown, but has just enough time to gasp "Why?" Replies the scorpion: "It's my nature..."[1]

INTRODUCTION

On April 4th, 2012, President Obama signed into law new legislation regulating insider trading by Members of Congress. Commonly known as The STOCK Act[2] (Stop Trading on Congressional Knowledge), this is the first legislation to restrict Members of Congress and their employees from trading on material non-public information.

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The legislation was initially proposed by Representative Louise Slaughter[3] in 2006, but received little support and languished in committee for five years. Then, in November of 2011, CBS television aired a 60 Minutes program in which it "reported that Members of Congress can legally trade stock based on non-public information from Capitol Hill."[4] The show generated wide-spread, public outrage at the thought that Congress was above the law. The piece exposed specific Members of Congress, such as Nancy Pelosi,[5] using insider information to make huge profits on initial public offerings. In response, the legislation gained a new co-sponsor (Joseph Lieberman), public support by President Obama, and bipartisan support in both the House and Senate, resulting in its nearly unanimous passage in March, 2012.

The significance of this legislation cannot be overstated. The perception that illegal insider trading runs rampant in Congress adds to citizen dissatisfaction with government and fosters cynicism about both the markets and the legislative process. This legislation sends a clear signal that Congress is not above the law.

As discussed below, the legislation resolves some long-standing confusion about the application of the 1934 Securities Exchange Act Section 10(b) and the Security Exchange Commission's (SEC) Rule 10b-5 to Members of Congress and its employees. Nevertheless, strong arguments exist that the legislation was unnecessary and the real problem lies in the failure of the SEC to prosecute Congressional insider trading cases. This paper will weigh the arguments in favor of the new law against the key provisions of the STOCK Act and then discuss whether the Act will remedy the problems outlined.

THE QUANTITATIVE ANALYSIS

One of the motivating factors behind this legislation was the wide-spread belief that Members of Congress made profits far in excess of the general public. The first part of this paper will discuss whether this premise is true.

Most finance academicians and practitioners interpret profit earned on any investment as normal or abnormal by applying the concept of cumulative abnormal returns (CARs) which is commonly used in event studies. The CARs refer to the investment performance that generated returns over and above the risk adjusted required rate of return embedded in the Capital Asset Pricing Model (CAPM). This model classifies risk associated with investments as unsystematic risk (which can be diversified away with 12-20 stocks in a portfolio and therefore not compensated for in the market) and market or systematic risk (which is rewarded for based on the level of risk associated with each firm). The CAPM equation calculates a weighted risk premium based on the specific stock held as part of a portfolio. These models assume that the U. S. capital markets are efficient and an investor can outperform the market only by having access to non-public and market moving information.[6]

The Wall Street Journal first reported in May 2010 that Members of Congress had been engaging in illegal stock trading based on non-public information. Some Members of Congress were also betting against the stock market using leveraged exchange-traded funds.[7] Two major academic studies conducted in 2004[8] and 2011[9] published mixed findings about the profits made by the Members of Congress.

The earlier study of the Senate inferred that based on their position and the social access they enjoy, the Senators were knowledgeable about the appropriate times to buy and sell their

investments in common stocks. The authors speculated that the ways in which Senators raise campaign money may be one of the major reasons for access to private information. The buy and sell investment decisions by the Senators outperformed the market by 0.97 percent per month, almost 12 percent annually, and the results were statistically significant. After the Senators sold their stock, the rate of return turned negative, indicating that the Senators knew exactly when to sell. While there was no difference based on party affiliation, Senators in their first term generated higher returns compared to their more senior peers.[10]

The second study shifted attention to the Members of the U.S. House of Representatives. The authors hypothesized that the informational advantage may be more diluted in the House (435 representatives) compared to the Senate (100 senators). The buy investment decisions by the House Members outperformed the market by 0.55 percent per month, over 6 percent annually, (smaller compared to the Senate) and the results were statistically significant. The level of returns increased with the size of investment. Unlike the Senate, the House Democrats' investments outperformed the House Republicans' investments. Similar to the Senate, seniority did not appear to help to generate higher profits.[11]

It is interesting to note that few academicians have attempted to study this area of market inefficiency. Some of the reasons for this lack of interest are most likely based on the reliability of the information filed by the Senators and the Members of the House. First, the forms can be handwritten making them difficult to read. Second, no specific documentation is necessary. Zibrowski and his colleagues found[12] that some disclosures had actual brokerage statements attached to them. However, some forms used abbreviations and other terms which were impossible to interpret. Third, no

outside auditors verify the accuracy of the information provided. And last, the profits need to be reported only in terms of general ranges such as $100,001 to $250,000. Any researcher will have to make subjective judgments about whether the actual profit is closer to the lower or higher number in the range or in the middle.

Based on these two academic studies and other media reports, it is clear that some Senators and Representatives in the House have access to market-moving and non-public information which they have used to not only identify the stocks they should buy but also when they should sell their investments.

DO MEMBERS OF CONGRESS HAVE A LEGAL DUTY NOT TO TRADE ON INSIDE INFORMATION?

Prior to passage of the STOCK Act the question of whether or not Members of Congress were subject to federal securities laws had been hotly debated. There were two major concerns: first, were Members of Congress fiduciaries? And, if so, to whom? Second, how would one go about proving that a Member of Congress who traded stocks did so based on material inside information, as opposed to non-material information?

a. The Problem With Fiduciary Duty

The anti-fraud provisions of the federal securities laws encompassed in Section 10(b) and SEC Rule 10b-5 prohibit insider trading on material non-public information when to do so would violate a duty of trust or confidence.[13] Established case law holds that there must be a fiduciary duty between the person engaging in the illegal trading and the corporation. The leading case is *Texas Gulf Sulphur*,[14] in which members of the

board of directors learned of an ore deposit in Canada, and bought shares of stock before the public announcement. Under what is commonly called the "classical theory" of insider trading[15], insiders must abstain from trading or recommending securities until such inside information becomes public. "(The) duty to disclose arises from the *relationship between parties* and not merely from one's ability to acquire information because of his position in the market."[16]

Persons with a fiduciary duty who have a duty to disclose are defined as "officers, directors, or controlling stockholders" who have an "affirmative duty of disclosure ... when dealing in securities"[17] as well as tippees.[18] Under this theory, in order for Members of Congress to be liable for insider trading they would have to be in a fiduciary relationship with the corporations' stock they trade, or with the Government, or perhaps be deemed employees of the Government. No statute or precedent under insider trading laws places Members in such a position, however.

Arguably, appointed and elected public officials *could* be considered fiduciaries for the United States or the citizen collective. For example, some courts have suggested that Congressmen and women become "temporary insiders" of the corporation when they are legitimately given access to confidential corporate information solely for corporate purposes, or they become "tippees" by receiving inside information improperly.[19] In this capacity, they "…acquire independent fiduciary duties to the corporation and to its shareholders, and thus commit fraud within the meaning of Section 10(b) and Rule 10b–5 when they breach their fiduciary or similar duty of trust and confidence."[20] Importantly, the STOCK Act resolves this issue concerning whether Members of Congress are in fact fiduciaries, as will be discussed below.

b. The Problem With Materiality

In addition to requiring a fiduciary relationship, securities law also requires that to be guilty of insider trading, the information garnered must be material, nonpublic information. To be "material", there must be a substantial likelihood that a reasonable investor would consider the information important in making an investment decision.[21]

Suppose a Member of Congress sits on a committee and learns information about a particular company. The committee may just be one stop in a long road before legislation is passed. Nevertheless, suppose that the Member of Congress purchases stock based on the information he learned a year before. Further suppose that since wending its way through that particular legislator's committee, the legislation has gone through significant transformations and is now unrecognizable from the original. Is the bit of information that the legislator gleaned from a committee meeting "material" when the final, enacted legislation has no resemblance to the original? And if so, how much does the initial legislation have to resemble final legislation for there to be liability?

These questions represent issues of proof with regard to materiality, and are unsettled in securities law. Likewise, due to their unsettled nature, the issue of materiality presents a second, considerable roadblock to pursuing a prosecution against Members of Congress. Yet, unlike the issue of fiduciary status, the issue of materiality is not so clearly resolved by the STOCK Act, leaving it open to further debate as to its meaning.

FAILURE OF ENFORCEMENT BY THE SEC

Assuming that Members of Congress do in fact have a fiduciary duty, and materiality is provable, then it would seem

to most members of the public that a successful prosecution would be inevitable. Unfortunately, despite this perception, the SEC has only brought charges once against a Member of Congress. Why would the SEC fail to prosecute?

One argument is that prior law has been so unclear that the SEC hesitated to bring a very public prosecution that it ultimately might lose. Indeed, the head of enforcement for the SEC testified before a House panel that, "If Congressional officials find the vicissitudes of a fiduciary-focused anti-fraud prohibition too vague and unsettling, Congress could expressly define and prohibit 'insider trading' and unmoor the offense from Rule 10b-5. New legislation along that line would be a welcome development."[22]

Another theory could be a reluctance to take on the very institution that funds it. This was the suggestion of one commentator[23] who noted that the SEC might be "reluctant to bite the budgetary hand that feeds it"[24] and that its reluctance is based on "a recognition that current law does not reach Members of Congress."[25]

In summary, these arguments represent the state of the law prior to passage of the STOCK Act and highlight why legislation was needed. Given the complexity of the various rulings, it is easy to see why the public had no idea, until the 60 Minutes report, that Congress was trading on inside information with impunity.[26]

THE ETHICAL DUTY NOT TO TRADE ON INSIDE INFORMATION

Even if the federal laws have been too ambiguous to utilize in a prosecution, what then of the extensive ethical rules that govern Congress? If proving materiality or a fiduciary

relationship has been too difficult, and even if the SEC does not want to be involved, certainly the ethics rules could be utilized to stop this unfair practice.

The separate ethics rules that govern both the House and the Senate appear to dismantle any ambiguity with regard to insider trading. According to Rule 37.1 of the House Ethical Rules, for example, "A Member, officer, or employee of the Senate shall not receive any compensation, nor shall he permit any compensation to accrue to his beneficial interest from any source, the receipt or accrual of which would occur by virtue of influence improperly exerted from his position as a Member, officer, or employee."[27] Senate ethics rules parallel those of the House.[28] The congressional rules should eliminate numerous problems: there is no issue of a fiduciary relationship or materiality; nor is the SEC policing its benefactor.

Yet, even with none of the above obstacles, it was only just this year, after the 60 Minutes report, that the House Ethics Committee began its first ever investigation into the trading practices of a Member of the House. In February of 2012, Representative Spencer Bachus of Alabama was charged with ethics violations. He leads the House Financial Services Panel, which is responsible for oversight of the United States' banking and financial industries. *The Washington Post* reported that Bachus is an avid trader, and according to his financial disclosure forms, some of his trades seem to coincide with major policy announcements by the federal government.[29] Perhaps not surprising, in April of 2012, the Committee exonerated Bachus on all charges.[30]

It seems obvious that Congress is not capable of regulating itself in this matter; otherwise, this would not be the first and only time that a Member of the House was brought before the Ethics Committee. Unlike the SEC, Congress' unwillingness to

pursue such investigations cannot be attributed to funding concerns. One likely reason is that Members of Congress are unwilling to give up the potential for personal financial gain.

WHAT DOES the STOCK ACT PROVIDE?

a. *Establishment of a Fiduciary Relationship*

The core provision of the Act, section 4, expressly affirms that Members of Congress are not exempt from insider trading laws and establishes a fiduciary relationship:

> *Members and employees are not exempt from the insider trading prohibitions arising under the securities laws, including the Securities Exchange Act of 1934 and Rule 10b-5 and amends the Securities Exchange Act of 1934 to declare that such Members and employees owe a duty arising from a relationship of trust and confidence to Congress, the U.S. government, and U.S. citizens with respect to material, nonpublic information derived from their positions as Members or congressional employees or gained from performance of the individual's official responsibilities.*[31]

This is a change of historic proportions, as the apparent reticence to prosecute to date has arisen, at least in part, from the fear that the lack of a fiduciary relationship would result in a loss for the SEC. In a noteworthy response to the enactment of the new law, on April 4, 2012, the House of Representatives Committee on Ethics sent a memorandum to all Members. The memorandum reiterated the fiduciary relationship spelled out in Section 4 of the STOCK Act.[32]

b. Disclosure of Financial Dealings

Members of Congress, their employees and senior executives must disclose financial dealings on a website to be

set up by the Office of Government Ethics. All filings, previously by paper, will now be electronic and publicly available.

Specifically, the act amends the Ethics in Government Act of 1978 (EIGA)[33] to require that all Members and employees report any stock trades greater than $1000.00 within 30 days, rather than once a year,[34] and prohibits the purchase of securities that are the subject of an initial public offering.[35] The Act also requires the respective congressional ethics committees to issue further guidelines for Members to better understand what is prohibited.[36]

CRITICISM OF THE ACT

a. The Speech & Debate Clause May Limit the Act

Article I, Section 6 of the U.S. Constitution provides Members of Congress immunity under the "Speech or Debate Clause"[37] for acts which they perform in the exercise of their duties[38] as well as for acts by their staff members.

In the famous Pentagon Papers case, the Supreme Court held that the clause applied to a grand jury investigation and covered congressional staff members whose acts are related to the legislative process to the same extent it applied to elected members.[39] Today, there seems to be wide-spread agreement that the clause does not protect criminal actions by Members of Congress if those acts have no relationship to a Member's job duties.[40] Consider an insider trading action, however. The information used by the Congressional Member or members of his/ her staff or others would be information generated in the pursuance of the legislative process, and thus be protected. Only the *use* of that information would be illegal, or unprotected. Nevertheless, for the SEC to successfully prosecute, subpoenas would have to be issued to cover the

legislative discussions and meetings, all of which are protected under the clause. Thus, it would be impossible to determine whether trading was based on insider information. Despite the new legislation, the Speech or Debate Clause will present a formidable obstacle to prosecution.

Given this factor, one must wonder if Congress may have passed this legislation knowing it could never be used against them; yet, in supporting the legislation it looked to the public as if Congress was policing itself. One commentator noted that if Congress intended to give the legislation any teeth, then it would have included an explicit waiver of this provision.[41]

b. The Act Does Not Address Hedge Fund Managers

To understand the next criticism of the law, it is first necessary to understand what is meant by the "political intelligence industry." While it is illegal to trade on insider information about public companies, it is not illegal to trade based on inside governmental information. Thus, inside information about pending legislation can be worth a great deal, particularly to hedge fund managers. Hedge funds are essentially a mutual fund like investment vehicle for extremely wealthy investors. Because of their presumably sophisticated clientele, they are not regulated, but that same aura leads hedge fund managers to promise returns way above the market benchmark. Since U.S. capital markets efficiently incorporate all publicly available information almost instantaneously, the only way hedge fund managers can beat the market is by having access to inside information. One way to ensure such access is to have people working in Washington, D.C. talk to Members of Congress on a regular basis. It is estimated that the cost of employing this political intelligence industry is about $400 million a year.[42]

When the legislation passed the Senate, it included a provision that required disclosure when workers passed inside governmental information to hedge funds. The House, however, deleted this requirement, opting instead to require a report by the U.S. Government Accountability Office and Congressional Research Service on the role of political intelligence firms in the financial markets. Much criticism of this deletion ensued. According to one legal commentator, "This could have been a lot more significant,… It's irresponsible for the leadership to have dropped the ball on requiring political intelligence agents to register. We could have exposed the secret flow of information between Washington and Wall Street."[43]

c. The Act Does Not Cover Real Estate

Another major criticism of the Act is that it does not cover real estate transactions. This means that if, for example, a Member of Congress learns in hearings about a water-front development in a certain city, there would be nothing illegal about that member purchasing contiguous property.

While the Act requires that members disclose personal mortgages when they file their first financial disclosure reports on May 15th, 2012, there is no mandate governing the reporting of “sweetheart mortgage terms” (very low interest rates with no down payment). When Angelo Mozilo was the CEO of Countrywide Financial Corp., such loans were readily available under the "Friends of Angelo (FOA)" VIP program. Some prominent congressional recipients included New York Democrat Edolphus Towns, two Senate Democrats, Christopher Dodd of Connecticut and Kent Conrad of North Dakota. In 2010, Mr. Issa, chairman of the House Oversight and Government Reform Committee, advised Senate ethics

investigators that about thirty VIP loans had been made to Senate employees.[44]

Since real estate sales and purchases can be as lucrative as stocks, it is perplexing why this area was exempted from coverage in the Act. Some commentators have gone so far as to recommend that members of Congress place all of their holdings, including real estate, into mandatory blind trusts. "The STOCK Act does nothing to deal with land deals or other graft that is taking place. It only deals with insider trading."[45] Blind trusts are another modification that was rejected by Congress when amendments were proposed.

d. Adequacy of Disclosure

In addition to the omissions noted above, there are significant problems with the timing and degree of disclosure that is required. The Act does not require reporting of the level of profits made through stock trading relative to a market benchmark. Simply reporting how many shares of a particular company were bought and/or sold does not reveal whether any inside information was used to make decisions about the trades. Allowing 30 days to file information about stock trades is old news by today's standards of flash trading. Small movements in price are used by major traders to place buy and sell orders extremely quickly, literally in seconds. Nor is there any express provision about the necessary documentation (e.g. brokerage statements) which must be provided at the time of filing the information on stock trades. In addition, it is not clear whether any independent audits will be conducted to verify the accuracy of the reports filed.

e. Unintended Consequences

While the new Act clearly prohibits trading on insider information, "…the new legislation leaves unanswered practical questions about whether and when a person who learns information from dialogue with a covered person has become a 'tippee' under the securities laws, and therefore must refrain from trading securities whose value may be materially affected by the disclosure of the information impacted."[46] Perhaps the new law will make Members or their tippees hesitant about trading on insider information, and most will cautiously refrain when in doubt. At the same time, it may chill the flow of important information between Members, staff, the press and the public.

CONCLUSION

On its face, the STOCK Act appears to be a "win-win" for both Members of Congress and the public. From a public perspective, insider trading by Congress will no longer be allowed, thus leveling the playing field. Disclosure requirements should result in greater transparency in government. In a rare demonstration of bipartisanship, Congress and the President can claim a legislative success.

Express application of the SEC laws to Congress and the establishment of a fiduciary relationship is the core of the Act. Coupled with the increased public disclosure obligations, one would hope that now Members of Congress will think twice before trading on inside information. It is still up to the SEC and the Senate and House Ethics Committees, however, to actively enforce these provisions and establish additional disclosure guidelines. Given their past reluctance to prosecute, as well as the gaping holes in the new law, it seems more likely that negative campaigning and media exposés will continue to be the drivers of the renewed focus on insider

dealings. Unfortunately, given Congress' "nature," the STOCK Act seems deliberately limited in scope.

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[1] *Aesop's Fables*, *The Scorpion and the Frog,* http://www.aesopfables.com/cgi/aesop1.cgi?4&TheScorpionandtheFrog

[2] The House version of S2038 was unanimously passed by the Senate on March 22, 2012; presented to President Obama on March 28, 2012 and signed in to law on April 4, 2012. Hereafter referred to as S2038.

[3] Congresswoman Louise M. Slaughter, *President Obama Praises Slaughter for Her Work to End Insider Trading in Congress as he Signs STOCK Act into Law*, Apr. 5, 2012, http://www.louise.house.gov/index.php?option=com_content&view=article&id=2701:president-obama-praises-slaughter-for-her-work-to-end-insider-trading-in-congress-as-he-signs-stock-act-into-law&catid=101:2012-press-releases&Itemid=55

[4] CBS News, *Congress: Trading Stock on Insider Information?* Nov. 13, 2011, www.cbsnews.com/video/watch/?id=7388130n.

[5] George Zornick, *Looking Closer at Congressional Insider Trading*, Nov. 18, 2011, http://www.thenation.com/blog/164705/looking-closer-congressional-insider-trading.

[6] For a detailed discussion of the CAPM and other similar theories *see* E.F. BRIGHAM & P.R. DAVIES, INTERMEDIATE FIN. MGMT., SouthWestern/Cengage Learning (10th ed. 2010).

[7] Jason Zweig, Tom McGinty, & Brody Mullins, *Congress Members Bet on Falls in Stock,* THE WALL ST. JOURNAL, May 3, 2012.

[8] Alan J. Ziobrowski, Ping Cheng, James W Boyd, and Brigitte, *Abnormal Returns from the Common Stock Investments of th U.S. Senate*, Vol. 39, No. 4, JOURNAL OF FINANCIAL AND QUANTITATIVE ANALYSIS 661-676, Dec. 2004.

[9] Alan J. Ziobrowski, Ping Cheng, James W Boyd, and Brigitte, *Abnormal Returns from the Common Stock Investments of the members of the U. S. House of Representatives,* Vol.13, Issue 1, Art. 4, BUSINESS AND POLITICS, 2011.

[10] Ziobrowski, *supra* n. 8.

[11] Ziobrowski, *supra* n. 9

[12] Id.

[13] 10 b-5 provides that it is illegal, "For any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the

mails or of any facility of any national securities exchange,(a) To employ any device, scheme, or artifice to defraud,(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b–5 (2010).

[14] Sec. and Exch. Comm'n v. Tex. Gulf Sulfur Co., 401 F. 2d. 833 (2d Cir. 1968).

[15] *See* Micah A. Acoba, *Insider Trading Jurisprudence After United States v. O'Hagan: A Restatement of Torts (Second) of Torts § 551(2) Perspective*, 84 CORNELL L. REV. 1357 (1999).

[16] *Tex. Gulf*, 401 F. 2d. at 848.

[17] In re Cady, Roberts & Co., 40 S.E.C. 907, 911 (1961).

[18] "A tippee, however, is not always free to trade on inside information. His duty to disclose or abstain is derivative from that of the insider's duty. Tippees must assume an insider's duty to the shareholders not because they receive inside information, but rather because it has been made available to them improperly. Thus, a tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach". See *Dirks v. SEC*, 463 U.S. 646 (1983).

[19] Sec. and Exch. Comm'n. v. Lund, 570 F.Supp. *1397* (D.C.Cal.,1983). The court coined a new classification the "temporary insider." They assume the duties of an insider temporarily, by virtue of a special relationship with the corporation. A temporary insider is subject to liability under § 10(b) for trading on the basis of nonpublic information.

[20] Sec. and Exch. Comm'n v. Tome, 638 F. Supp. 596, 617 (S.D.N.Y. 1986).

[21] Basic Inc. v. Levinson, 485 U.S. 224, 227–228 (1988).

[22] Donna M. Nagy, *Nagy: Enforce Laws to Fight Insider Trading*, Special to Roll Call, Oct. 11, 2011, http://www.rollcall.com/issues/57_40/donna_nagy_enforce_laws_fight_lawmaker_insider_trading-209378-1.html?zkMobileView=true.

[23] Stephen M. Bainbridge, *Insider Trading Inside the Beltway,* 36 J. CORP. L. 281, 295, n. 101 (2011).

[24] Stephen Bainbridge, *Does the STOCK Act's Impending Passage Argue for Self-Funding by the SEC?* Feb. 13, 2012,

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http://www.professorbainbridge.com/professorbainbridgecom/2012/02/does-the-stock-acts-impending-passage-argue-for-self-funding-by-the-sec.html.
[25] Id.
[26] *See* e.g. Stuart P. Green, *Should Insider Trading by* Congress *Be Allowed?* Procon.org, May 2008, http://insidertrading.procon.org/view.answers.php?questionID=001314.
[27] Office of Congressional Ethics. United States House of Representatives, Code of Conduct http://oce.house.gov/pdf/OCE_Code_of_Conduct.pdf (Amended September 27, 2011).
[28] The Senate Code of Official Conduct, Select Committee on Ethics, Apr. 2008, http://ethics.senate.gov/public/index.cfm/files/serve?File_id=efa7bf74-4a50-46a5-bb6f-b8d26b9755bf.
[29] *See* Scott Higham and Dan Keating, THE WASH. POST, Feb. 9, 2012, http://www.washingtonpost.com/politics/rep-bachus-faces-insider-trading-investigation/2012/02/09/gIQA21Ui2Q_story.html, (reporting that "the case is the first of its kind involving a member of Congress.)
[30] Scott Higham, *Congress Ethics Office Clears Bachus of Insider Trading*, THE WASH. POST, Apr. 30, 2012, http://washingtonpost.com/investigations/.../gIQAVwvZsT_print.html.
[31] The White House, Office of the Press Secretary, *FACT SHEET: The STOCK Act: Bans Members of Congress from Insider Trading from The White House*, Apr. 4, 2012, http://www.whitehouse.gov/the-press-office/2012/04/04/fact-sheet-stock-act-bans-members-congress-insider-trading.
[32] The text of the Act is set out in full at http://www.gpo.gov/fdsys/pkg/BILLS-112s2038enr/pdf/BILLS-112s2038enr.pdf.
[33] U.S. House of Representatives, Jo Bonner, Chairman of Committee on Ethics, Apr. 4, 2012, http://ethics.house.gov/sites/ethics.house.gov/files/Stock%20Act%20Pink%20Sheet.pdf.
[34] (Sec. 6) Amends the Ethics in Government Act of 1978 (EGA) to require specified individuals to file reports within 30 to 45 days after receiving notice of a purchase, sale, or exchange which exceeds $1,000 in stocks, bonds, commodities futures, and other forms of securities and subject to any waivers and exclusions.
[35] (Sec. 12) Amends the Securities and Exchange Act of 1934 to prohibit individuals required to file financial disclosure reports under EGA from purchasing securities that are the subject of an initial public offering in any manner other than is available to members of the public generally.

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[36] (Sec. 3) Requires the congressional ethics committees to issue interpretive guidance of the rules of each chamber, including rules on conflicts of interest and gifts, with respect to the prohibition against the use by Members of Congress and congressional employees (including legislative branch officers and employees), as a means for making a private profit, of any nonpublic information derived from their positions as Members or congressional employees. (Sec. 9) Requires the Office of Government Ethics to issue interpretive guidance of the relevant federal ethics statutes and regulations, including the Standards of Ethical Conduct for executive branch employees, to specify that no such individual may use non-public information derived from his or her position or gained from the performance of official responsibilities as a means for making a private profit.

[37] U.S. Const. art. I, § 6, cl. 1. "And for any speech or debate in either House, they shall not be questioned in any other place".

[38] U.S. v. Brewster, 408 U.S. 501(1972).

[39] For example, at the height of Richard Nixon's presidency, Daniel Ellsberg leaked the Pentagon Papers to Senator Mike Gravel from Alaska, who then leaked all of the content to the public by reading it into the Buildings and Grounds Subcommittee of the Senate's Environment and Public Works Committee (thus "publishing" its content). In a subsequent criminal prosecution, members of the Senator's staff were subpoenaed. The subpoena was challenged under the Speech or Debate Clause. Peter J. Henning, *Murky Signals for Congress on Insider Trading,* N.Y. TIMES, Nov. 25, 2011, http://dealbook.nytimes.com/2011/11/25/murky-signals-for-congress-on-insider-trading/.

[40] Id. "The House of Representatives filed briefs challenging a search by Federal Bureau of Investigation agents of the office of Representative William J. Jefferson, Democrat of Louisiana, in May 2006 and the wiretapping of Representative Rick Renzi, Republican of Arizona, in 2007, arguing that these tactics in criminal corruption investigations violated the privilege of members of Congress not to have legislative information disclosed. In neither case was the congressman questioned, but the constitutional protection extends beyond just examining witnesses. Mr. Jefferson was convicted of bribery and other charges in 2009 and sentenced to 13 years in prison, and Mr. Renzi is awaiting trial in Arizona on corruption charges.

[41] David Zeiler, *STOCK Act: Latest Political Flimflam Won't Stop Worst Abuses*, Money Morning, Apr. 4, 2012,

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http://moneymorning.com/2012/04/04/stock-act-latest-political-flimflam-wont-stop-worst-abuses/.

[42] Lena Groeger, *Taking Stock of the Stock Act: A Side-by-Side Comparison,* Pro Publica Inc., Mar. 12, 2012, http://www.propublica.org/special/taking-stock-of-the-stock-act-a-side-by-side-comparison.

[43] Zeiler, *supra* n. 38.

[44] John R. Emshwiller, *House Members Received VIP Loans; Oversight Panel Raises Concern of 'Possible Wrongdoing' in Borrowings from Countrywide Financial by Four in Congress*, THE WALL ST. JOURNAL, Dec. 19, 2011.

[45] Peter Schweizer, *Obama Signs STOCK Act Prohibiting Congressional Insider Trading: But there's More to Be Done*, Yahoo! Finance, Apr. 4, 2012, http://finance.yahoo.com/blogs/daily-ticker/obama-signs-stock-act-still-more-done-peter-172415917.html.

[46] Brad S. Karp, *Unintended Consequences of the STOCK Act,* The Harvard Law School Forum on Corporate Governance and Financial Regulation, Mar. 14, 2012, http://blogs.law.harvard.edu/corpgov/2012/03/14/unintended-consequences-of-the-stock-act/.

INTERNATIONAL TAX LAW: TRANSFER PRICING FOR ASSETS, GOODS AND SERVICES

by
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INTRODUCTION

The Organisation for Economic Co-operation and Development (OECD), whose signatories include the United States and 33 other member countries, has adopted a series of "soft law" guidelines similar to the "hard law" regulations enacted in the U.S. Internal Revenue Code (IRC) concerning tax upon transfer pricing among related multinational businesses or enterprises (MNE) not dealing at arm's length. International transfer pricing rules regulate yearly local jurisdictional taxes[1] which measure in the trillions of dollars. In 2006, for example, the MNE pharmaceutical firm GlaxoSmithKline settled a transfer pricing controversy with the US Internal Revenue Service for $3.4 billion[2]. The Guidelines of the OECD and the regulations of the IRC allocate taxes for loans, sales of tangible property, transfers of intangible property, and services between related persons, such as a multinational parent and its subsidiary corporation[3]. This article outlines the methods of valuation used by the IRC and

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its regulations, which have served as models for the OECD guidelines.[4] The article also examines a number of United States taxation case controversies describing the difficulties encountered in applying any tax allocation and assessment systems. These cases include the 1979 landmark *E I Dupont*[5] decision, the 1988 *Eli Lilly*[6] tax allocation case, the 2002 *DHL*
decision, the 1988 *Eli Lilly*[7] tax allocation case, the 2002 *DHL*
v. Commissioner of Internal Revenue[8] trademark controversy and a 2010 Ninth Circuit decision, *Xilinx, Inc. v. Commissioner of Internal Revenue*[9], which outlines the presently raging cost-sharing arrangement controversy. This article concludes that any simplification of the processes described will indeed be difficult because the transfer pricing devices used by multinational businesses become quite complex as those businesses attempt to avoid tax liabilities.

SECTION 482 AND REGULATIONS UNDER THIS SECTION

Section 482

The United States Internal Revenue Code Section 482 and its Regulations describe the taxation of ordinary income and deductions among controlled taxpayers. As observed above, OECD Guidelines are mirrored in the Code and Regulations. The analysis which appears in this article, therefore, will apply to both the Code and the Guidelines, even though our examination of the rules concentrates upon the Internal Revenue Code and its Regulations.

The complete statement of Section 482 follows:

> *§ 482 Allocation of income and deductions among taxpayers*. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and

> whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property, the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.[10]

As stated in the Regulations, the purpose of Section 482 is to require taxpayers to clearly state income attributable to their controlled transactions: the Code section seeks to render a controlled taxpayer equal to uncontrolled taxpayers in the determination of their true taxable income. Regulation Sections 1.482-1 through 1.482-9 seek to aid the controlled taxpayer by providing general principles and guidelines to be followed under section 482. Section 1.482-1 contains a general statement of purpose and outlines the methods for determining taxability. Section 1.482-2 describes general rules for controlled taxpayers in specific situations, including loans or advances and the use of personal property. Section 1.482-2A generally governs the transfer or use of intangible property. Section 1.482-3 describes the methods used to determine taxable income when tangible property is transferred. Section 1.482-4 concentrates upon methods used to determine tax upon the transfer of intangible property. Section 1.482-5, Section 1.482-6 and Section 1.482-8 describe new methods or explain old methods which may be used in the computation of taxable income, including the comparable profits method, the profit split method and examples of the best method rule. Section

1.482-7 and Section 1.482-7A describe methods to determine the presently controversial topic of taxable income in connection with a cost sharing arrangement. Section 1.482-9 outlines methods to determine taxable income when a controlled services transaction occurs.

Pre-requisites to Apply Regulations: Two or More Organizations; Common Ownership or Control: Tax Evasion Prevention

Section 482 requires three determinations before it is applied. The regulations note that an organization includes any sole proprietorship, partnership, trust, corporation or any other kind of organization, whether it is taxable or tax exempt, and whatever its location is. [11] The organizations, however, must also be owned or controlled by the same interests and the reality of the control is decisive, not its form.[12] In addition, an IRS determination that a transfer pricing reallocation is necessary to prevent tax evasion will not be overturned by the courts unless, as stated in the general rule concerning non-judicial decisions, the determination can be seen to be arbitrary and capricious.[13]

Methods to Determine the Allocation of Income and Deductions among Controlled Taxpayers

The regulations describe a standard and methods to determine the allocation among controlled taxpayers. An arm's length standard measures taxability. Then a number of methods may be used to determine the tax; the methods are numerous and complex in order to match the remarkable complexity of marketplace realities. Methods include the comparable uncontrolled price method, the resale price method, the cost-plus method, the comparable profits method, the profit split

method and unspecified methods to be determined by the particular facts of a case.

Arm's Length Standard

Regulation 1.482-1 unequivocally states that "in order to determine 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". The regulation, however, indicates that because identical situations can rarely be found, a number of methods will assist in discovering the arm's length value of the taxable income.

Methods to Determine Taxable Value

The standard of comparable uncontrolled prices is often used. This comparability test will occur in situations where similar loans, tangible property, intangible property, services or cost-sharing arrangements exist. The comparability test will include a number of factors including the functions of the arrangement; its contractual terms and risks and its economic conditions. The standard of comparability may vary depending upon whether or not property or services or other intangibles are being transferred. This comparable uncontrolled price method is favored if it is available, but the best method must always be used to accurately determine taxability; the other methods therefore must always be computed by the tax attorney or accountant.

The resale price method applies to products alone and verifies the market sale of a product from the buyer's perspective. The cost-plus method examines the same product sale from the seller's perspective.

The comparable profits method examines the situations of similar taxpayers who buy and sell the same product or services. The profit split method examines the contributions to the product and returns from its sale by the same or similar tax payers.

Unspecified methods are combinations of the above methods or methods peculiar to the facts of a particular taxable situation.

The regulations note that a number of different methods may apply to any transfer pricing situation but the best method, the one which provides the most reliable measure of an arm's length result, must be chosen.

DETERMINATION OF TAXABLE INCOME IN SPECIFIC SITUATIONS

Regulation 1.482-2 Loans or Advances

Loans or advances occur when a member or group of controlled entities make a loan or advance to a controlled entity which charges no interest or interest at a rate less than an arm's length rate of interest. The applicable federal rate of interest for a bona fide debt incurred made at arm's length will help to determine the arm's rate interest rate in accordance with the following criteria: if the loan or advance term is not over three years, the federal short-term rate will apply; between five years and nine years, the federal mid-term rate will apply; over nine years, the federal long-term rate will be used.[14]

Regulation 1.482-3 Tangible Property Transfer

A tangible property transfer arm's length amount will be determined according to all of the following six methods: the comparable uncontrolled price method; the resale price method; the cost-plus method; the comparable profits method; the profit split method and unspecified methods. The regulations note that everyone of the methods should be applied in order to determine the best method of comparability.[15]

The 1979 United States Court of Claims decision *E.I. du Pont v. The United States*[16] describes a situation in which the plaintiff du Pont sold textile products to its subsidiary in Switzerland. In 1959 du Pont created a wholly-owned Swiss marketing and sales subsidiary, du Pont International S.A. (DISA). Most of du Pont's products were sold abroad through this subsidiary and du Pont claimed U.S. taxable income only upon the prices charged to DISA and not upon the sales to ultimate consumers made through independent distributors. The Commissioner of Internal Revenue decided that the division of profits was meant to evade U.S. income tax. The Commissioner reallocated a substantial portion of the subsidiary's income to the plaintiff parent.

Due to telling intra-office communications and to the evidence adduced by the government, the United States court of claims concluded that the plaintiff was not entitled to any refund of taxes paid in accordance with the reallocation order. The court, at du Pont's suggestion agreed that the comparable uncontrolled price method could not function to determine the reallocation nor could the cost-plus method. The court instead made its decision in accordance with the retail price method which "reconstructs a fair arm's length market price by discounting the controlled reseller's selling price by the gross profit margin (or markup percentage) rates of comparable uncontrolled dealers".[17] The court used two economic indices

prepared by the Commissioner which indicated that six managing consulting firms, five advertising firms and twenty-one distributorships had comparable ratios of gross income to total operating costs which were less than half of DISA's ratio during the same period of time and that some 1,133 companies had a rate of return upon their investments less than 2% of DISA's rate of return. The court concluded that the Commissioner's reallocation of du Pont's taxable income for the years 1959-1960 was certainly fair and reasonable.[18]

Regulation 1.482-4 Intangible Property Transfer

Intangible property transfers, on the other hand, use only four types of methods to determine the comparable arm's length amount: the comparable uncontrolled transaction method, the comparable profits methods, the profit-split method, and "unspecified methods"[19]. The regulations note that intangible property includes patents, inventions, designs, copyrights, trademarks, trade names, franchises, licenses and contracts. Specific rules for intangible property include examination of the form of consideration paid between the controlled parties and periodic adjustment of that payment in accord with the profitability of the intangible property.

The 1988 United States 7th Circuit Court of Appeals decision *Eli Lilly v. Commissioner of Internal Revenue*, previously mentioned, describes the transfer of patents and manufacturing processes to Lilly's Puerto Rico subsidiary, Lilly PR.

According to the parent's tax saving plans, Lilly PR manufactured prescription drugs, including Darvon and Darvon-N, in Puerto Rico, thereby taking advantage of tax incentives provided by both federal and Puerto Rican law. The parent then purchased these drugs from its subsidiary and

resold them in the United States. The Commissioner reallocated income to the parent in the U.S., arguing that the parent's transfer of its patents and manufacturing expertise in exchange for stock in the subsidiary was not an arm's length transaction which entitled Lilly to allocate income derived from the assets totally to Lilly PR.

The Court upheld the United States Tax Court decision of taxability for a number of cost adjustments, but found that the Commissioner had no basis to reallocate the company's general research and development expenses.[20] The tax deficiency ultimately amounted to some $ 17 million for the tax years 1971 through 1973 after the allowance for the research and development exemption.[21] The Appeals Court agreed with the Tax Court that Lilly could validly transfer its intangible patent rights and manufacturing processes to Lilly PR because federal and local law encouraged the investment exchange and the establishment of the subsidiary did not have the sole purpose of evading tax, a device explicitly forbidden by Section 482.[22]

The Appeals Court upheld the conclusion of the Tax Court that the Darvon product transfer prices did not represent arm's length dealings and that tax adjustments were necessary. In determining Lilly's tax liability, the Appeals Court listed four possible applicable methods: comparable uncontrolled prices; resale price method; cost plus method; or other appropriate method.[23]

For the 1971 and 1972 tax years, while the Darvon products' patents were still in effect, both courts found that a fifth alternate appropriate method, the profit split method, would be most appropriate in the peculiar circumstances of the case – none of the other methods, including the last as used to date, would yield an accurate assessment.[24] "The profit split

approach divides combined revenues based on an ad hoc assessment of the contributions of the assets of the commonly controlled enterprises."[25] The court decided that although only an estimate, Lilly and Lilly PR rates of return upon their investments, less manufacturing and marketing expenses, should be divided 45% to Lilly and 55% to Lilly PR.[26]

For the 1973 tax year, after the Darvon products' patent rights had terminated, the courts easily used the comparable uncontrolled price method to determine the tax liability by comparing Lilly's transactions with those of competing drug manufacturer-sellers.[27]

The 2002 United States Court of Appeals for the 9th Circuit decision *DHL Corporation v. Commissioner of Internal Revenue*[28] describes an intangible property valuation which nonetheless exonerated the corporation from any tax liability. The Appeals Court in this case overruled the Tax Court assessment and penalties. The decision reasoned that the "DHL" trademark profits arising from the plaintiff's sale of that intangible property trademark to a third-party Consortium was not equitably owned by the DHL Corporation and could not result in domestic tax liability.

Document Handling Limited (DHL), a package delivery company, was incorporated in California in 1969; within three years, Document Handling Limited, International (DHLI) was incorporated in Hong Kong to process all international deliveries. All U.S. deliveries continued to be made by DHL. Even though DHL experienced some financial reversesals over the years, DHLI grew tremendously. In 1992, an international consortium of investors purchased a majority of the stock of DHLI and its overseas operating agent MNV; the consortium

also purchased the DHL trademark for international use, valuing the trademark at $20 million.[29] In 1995, the Commissioner of Internal Revenue issued a tax deficiency and penalty notice against DHL for the tax years 1990 through 1992. The Commissioner contended that the trademark's value equaled $100 million and was deliberately undervalued by the consortium to avoid the payment of taxes due; royalties for the use of the trademark, furthermore, should have been paid by DHLI to DHL, but were not. The Tax Court upheld the Commissioner's jurisdiction under Section 482, and the tax deficiencies and penalties.[30]

The Court of Appeals affirmed the Commissioner's authority to investigate the situation in accord with the prohibitions under Section 482, but unequivocally indicated that the tax deficiencies and penalties were assessed in error. The Appeals Court observed that the reality of the DHL/DHLI business relationship indicated that the two companies were commonly controlled; their selling negotiations with the third party Consortium did not remove DHL from the Commissioner's Section 482 jurisdiction. The Court also indicated that the intangible trademark was used in a situation by DHL and by DHLI which were not at arm's length.[31] The valuation of the transfer, however, for DHL was misperceived.

The Court held that, although the legal title of the trademark was in DHL, its equitable title belonged to DHLI. Under the plain language of the 1968 tax regulation applicable to the 1992 negotiations and sale, the Commissioner and the Tax Court should consider the following four factors:

(1) the relative costs and risks borne by each controlled entity;
(2) the location of the development activity;
(3) the capabilities of members to conduct the activity independently;

(4) the degree of control exercised by each entity.[32]

The Court strongly indicated that the Commissioner and the Tax Court failed to apply these relevant factors. DHLI developed and strengthened the DHL trademark in the international arena by its overseas service advertising and promotional activities. Additionally, DHLI solely protected the foreign trademarks against infringement and settled all disputes relating to that infringement. DHL bore none of the costs of developing the foreign trademark. DHLI was the developer and DHL was not the assister: the developer-assister tax regulations do not help at all in determining tax liability.[33] Since DHLI was the developer, furthermore, DHL received no tax value from the sale of the trademark nor were royalties owed to it by DHLI. The Court concluded, then, that no DHL deficiency existed and that understatement penalties for the royalties and gross valuation misstatement for the trademark value should be forgiven.[34]

Regulation 1.482-7 and Regulation 1.482-7A Cost Sharing Arrangements

Cost-sharing arrangements also concern the transfer or use of intangible property. An arrangement is made in which controlled participants share the costs and risks of developing intangibles in proportion to their shares of reasonably anticipating benefits from the transaction. Once again, determination of the arm's length value of these arrangements requires the application of the methods of worth mentioned above, including the comparable uncontrolled price method, the resale price method, the cost-plus method, the comparable profits method, the profit split method and unspecified methods to be determined by the peculiar facts of a case.

A pressing present controversy concerns the 2010 cost-sharing stock option decision in *Xilinx, Inc. v. Commissioner of Internal Revenue.*[35] Xilinx, a U.S. researcher, developer, manufacturer and marketer of circuit devices and software systems, indirectly established a wholly owned Irish subsidiary, XI, in 1994. Subsequently, Xilinx and XI entered a Cost and Risk Sharing Agreement (Agreement) which mandated joint title in them for any new technology developed by either of them; the parties agreed to share all research and development costs including salaries and related purchases and costs. Nothing was said of employee stock options.

Xilinx then offered various stock options to its employees and XI followed suit in offering its employees options in Xilinx stock. In the tax years 1997 through 1999, Xilinx did not share the costs of these options to Xilinx with XI as related research and development costs. Xilinx instead claimed a number of business expenses for the tax year related to the options: $177 million based on employee exercise of the options; and $84 million as wages paid to assist the exercise of one of the options. In addition, the Court noted that XI paid Xilinx $1,454,131 for the "cost" of XI employee exercises of the Xilinx stock options.[36] The Internal Revenue Service (IRS), noticing the change in business expenses for these years, investigated the anomaly. The Commissioner then issued deficiency and penalty notices against Xilinx on the grounds that the Agreement required an equal sharing of all costs between the related corporations, including the costs of the stock options exercised by the Xilinx and XI employees. The Commissioner sought substantial tax deficiencies and penalties for Xilinx's failure to file accurate tax returns covering the tax years 1997 through 1999.

The United States Court of Appeals for the 9th Circuit ruled that the related companies in the United States and

Ireland were not required to share stock option compensation costs. The Court reasoned that an arm's length transaction would never include the sale of stock options, so the Section 482 allocation mandates could not be applied to the situation.[37] Judge Stephen Reinhardt dissented; he agreed with the Commissioner that the specific language of Regulation 1.482-7(d)(1) should prevail over the general language of Section 482 and explanatory Regulation 1.482-1 requiring an arm's length element as an ingredient for the application of Section 482.

The Internal Revenue Service continues to indicate that the *Xilinx* decision should not be relied upon by taxpayers and that reallocation will continue to occur. At a March 12, 2012 American Law Institute/American Bar Association webcast session,[38] Joseph Tobin of the IRS Office of Chief Counsel (International) reviewed the final, temporary and proposed Cost Sharing Agreement (CSA) tax regulations released by the Service in December 2011. Because these regulations have gone through an extensive notice and comment period, Mr. Tobin predicted that the *Xilinx* decision will no longer protect CSA arrangements which do not occur in arm's length transaction situations.[39]

Regulation 1.482-9 Controlled Services Transaction

Controlled services transactions occurred in the *du Pont* product distribution case, in the *Lilly* drug patent and manufacturing allocation decision, in the *DHL* trademark valuation and in *Xilinx* Cost Sharing Agreement controversy, but the valuations in those matters emphasized the principal portions of those disputes. Regulation 1.482-9 uses seven methods to arrive at the best comparable valuation of this controlled transaction: the services cost method, the comparable uncontrolled services price method, the gross services margin method, the cost of services-plus method, the comparable profits method, the profit split method and other

unspecified methods. Most of the methods are mirrored in the methods above which are used to evaluate tangible and intangible property; their complexity once again reflects the complexity of the marketplace and the tax evaluation process when applied to controlled entities.[40]

The services cost method provides guidelines for back office and support services valuations. The comparable uncontrolled services price method is analogous to the tangible property valuation by the same name, which compares uncontrolled prices for the service. The gross services margin method is similar to the tangible property resale price method in that it seeks to determine the profit margin realized in comparable uncontrolled transactions. The cost of services plus method mirrors the tangible property resale price method by determining the profit markup realized when the taxpayer provides those services to related or unrelated persons. The comparable profits method uses financial information available concerning unrelated persons and is applied to one who performs those services. The profit split method has been examined before in regard to tangible and intangible property and was used in fact in the *du Pont* decision to determine the relative proportion of profit between the related parties. Unspecified methods include all of the methods above and any methods peculiar to the transaction which help to determine its value.

CONCLUSION: THE NEED FOR THE SIMPLIFICATION OF OECD GUIDLINES AND IRC REGULATIONS

The descriptions of the methods and of the controversies above indicate the tremendous complexity used in applying the mandate contained in Internal Revenue Code Section 482 and

its regulations, as well as in the OECD guidelines which are directly modeled on the Code provisions.

At its March 28th 2012 meeting, the OECD Forum on Transfer Pricing resolved among 90 countries attending that transfer pricing rules need to be simplified and that, in particular, the guidelines concerning intangible property must be strengthened. The OECD Secretary-General Angel Gurria stated:

> [T]he time has come to simplify the rules and alleviate the compliance burden for both tax authority and tax payer, because complicated rules can be a barrier to cross-border trade and investment and place a heavy burden on tax administrations and businesses. We are making our approach simpler without making it arbitrary. [41]

The delegates to the conference resolved to publish a detailed specific manual to establish good practices for the assessment of transfer pricing risk at the beginning of an audit.

Many sovereign states, including Australia, have adopted the OECD Guidelines as law in their jurisdictions. These guidelines, as mentioned previously, originated from the wording and assessment methods of IRC Section 482 and its explanatory regulations.

The process of simplification, therefore, will require a continuing dialogue between the United States and other OECD members so that not only guidelines will be simplified but also the code provisions. At the present time of increasing assessment controversy, the possibility of simplification seems remote.

ENDNOTES

[1] Taxes by the US, not by the OECD or other international regulatory body.
[2] IRS news release IR-2006-142 (9-11-06); cited in *Better Than "Best": Transfer Pricing Methodology in the Wake of Roche*, 48 Columbia Journal of Transnational Law 140 (2009)
[3] Other types of related persons include subsidiaries among themselves.
[4] For an analysis of the Guidelines, see *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* at the *O*rganization for Economic Co-operation and Development webpage –
http://www.oecd.og/ctp/transferpricing/transferpricingguidelines
The guidelines, originally approved by the OECD council in 1995 and continuously amended since that time, include statements of the arm's length principle, transfer pricing methods, comparability analysis, special considerations for intangible property, intra-group services and cost contribution arrangements – all of which appear at length in the Internal Revenue Code Section 482 and its explanatory regulations.
[5] *E.I. du Pont v. The United States*, 608 F.2d 445 (1979)
[6] *Eli Lilly v. Commissioner of Internal Revenue*, 856 F.2d 855 (1988)
[7] *Eli Lilly v. Commissioner of Internal Revenue*, 856 F.2d 855 (1988)
[8] *DHL Corporation v. Commissioner of Internal Revenue*, 285 F.3d 1210 (2002)
[9] *Xilinx v. Commissioner,* 598 F.3d 1191 (2010)
[10] See https://checkpoint.riag.com/app/view/docText?usid
[11] Reg. 1.482-1(i)(1).
[12] Reg. 1.482-1(i)(4)
[13] See *Xilinx v. Commissioner,* 598 F.3d 1191 at 1195
[14] Reg. 1.482-2.
[15] Reg. 1.482-2.
[16] 608 F.2d 445, cited in endnote 4 above.
[17] 608 F.2d 445 at 450.
[18] 608 F.2d 445 at 456.
[19] Reg. 1.482-4.
[20] 856 F.2d 855 at 871-872.
[21] 856 F.2d 855 at 872.
[22] 856 F.2d 855 at 861-866.
[23] 856 F.2d 855 at 869.
[24] 856 F.2d 855 at 870.
[25] 856 F. 2d 855 at 871.

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[26] 856 F.2d 855 at 872; this change of percentage return represents a difference from a 1968 controversy agreement concerning Lilly in which the ratio was 40% to Lilly and 60% to Lilly PR.
[27] 856 F. 2d 855 at 872.
[28] 285 F.3d 1210
[29] 285 F.3d 1210 at 1215-1216.
[30] 285 F.3d 1210 at 1217.
[31] 285 F.3d 1210 at 1219.
[32] 285 F.3d 1210 at 1221.
[33] 285 F.3d 1210 at 1224.
[34] 285 F.3d 1210 at 1224-1225.
[35] 598 F.3d 1191.
[36] 598 F.3d 1191 at 1192.
[37] 598 F.3d 1191 at 1195 – 1197.
[38] Reported in *Tax Notes Today*, 4-23-12, by Julie Martin.
[39] See also *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009) for a CSA decision similar to *Xilinx.*
[40] See *The Bureau of National Affairs* publication, ISBN 978-1-55871-7978-5 pp. A-36, A-37 for a fuller analysis of the methods.
[41] *http://www.oecd.org/document/31/0*

DETERMINING WHETHER AN ACTIVITY IS A TRADE OR BUSINESS

by

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I. INTRODUCTION

In somewhat flowery language, the United States Supreme Court many years ago stated that:

"Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is a clear provision therefor can any particular deduction be allowed."[1] The Internal Revenue Code (Code) contains numerous provisions authorizing deductions.[2] Accordingly, taxpayers must find a relevant Code section and meet all of its requirements to be allowed a deduction in computing taxable income. Furthermore, some deductions may be reduced or even entirely eliminated. A notable example is medical expenses, which are deductible only to the extent exceeding 7.5% of adjusted gross income.[3] A deduction may also be limited to related income that is generated. For instance, the deduction for investment interest expense is limited to the amount of taxable *net investment income* reported on the taxpayer's tax return.[4] A deduction may be limited to a percentage of adjusted gross income. In point, is the charitable deduction, which is limited to a percentage of the taxpayer's contribution base (adjusted gross income disregarding any net operating loss carryback).[5] A deduction

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may also be subject to a *phase out*. The deduction for personal exemptions was reduced or eliminated if the taxpayer's adjusted gross income exceeded a threshold amount, which was modified each year for inflation.[6]

With respect to business expenses, it was not practicable to enact individual Code sections for the innumerable types of expenditures that businesses might incur. Consequently, the Code contains a generic provision, Section 162, which allows as a deduction "all the ordinary and necessary expenses paid or incurred in carrying on any trade or business." The section contains a reasonableness standard for compensation and disallows travel expenses that are "lavish or extravagant." There are also public policy considerations. No deduction is permitted for fines and penalties.[7] Nor is a deduction allowed for illegal bribes, kickbacks and certain other payments.[8]

A frequently recurring adversarial issue is whether an activity in which a taxpayer is engaged constitutes a "trade or business," which impliedly requires a profit motive. If the activity is not engaged in for profit, no deductions attributable to the activity are allowed, except to the extent gross income derived from the activity exceeds deductions that are allowable otherwise.[9] Moreover, deductions to the extent of gross income are allowed only if the taxpayer itemizes deductions. Even then, the amount deductible would be reduced by 2% of adjusted gross income.[10] Where non-business expenditures exceed gross income, or where there is none, such expenditures are considered of a personal nature and are not deductible unless there is a provision expressly providing otherwise.[11] Although business expenditures of a capital nature must be capitalized, the expenditure may be recoverable through depreciation or amortization deductions.[12]

II. CODE AND REGULATIONS

Code §183, captioned "Activities Not Engaged In For Profit," disallows deductions to individuals (and S corporations) with respect to an activity not engaged in for profit. However, deductions are allowed for expenditures that are deductible regardless of profit motive (e.g., real estate taxes related to the activity).[13] Also, deductions are allowed to the extent of income generated by the activity in excess of deductions that can be taken regardless of profit motive.[14] Section 183 is sometimes called the "hobby loss" section although technically it is not limited to activities that commonly are thought of as a hobby, sport or recreation.

Treasury regulations state that objective standards are to be used in determining whether an activity is engaged in for profit considering all of the facts and circumstances of each case.[15] There is no requirement that there be a reasonable expectation of profit. A small chance of making a large profit might suffice. One example is an investor in a wildcat oil well who incurs substantial expenditures although the expectation of a profit might be considered unreasonable. Most important are objective factors rather than mere statements of intent.[16]

The regulations contain several factors that normally are to be considered in making a determination. The factors listed are not intended as the only factors to be considered, nor is a determination to be made based on the number of factors indicating a profit motive or lack thereof.[17] The factors listed are:

1. Manner in which the activity is carried on. In essence, is it conducted in a businesslike manner?

2. Expertise of the taxpayer or advisors. Among other things, relevant would be the education and training of the taxpayer consistent with a profit motive.
3. Time and effort. Provided the activity does not have substantial personal or recreational aspects, a profit motive is indicated where the taxpayer expends considerable time and effort on the activity. A limited amount of time spent on the activity, however, does not necessarily negate a profit motive.
4. Expectation that assets will increase in value. For example, the expectation that land used in the business will increase in value so that, all things being considered, the activity will ultimately be profitable, although currently unprofitable.
5. Success in carrying on similar or dissimilar activities. A profit motive may be recognized if the taxpayer was able to convert unprofitable activities in the past to profitable ones.
6. History of income and losses. Losses in the startup phase of a business are common. If losses continue beyond what is common for that type of business, however, this might indicate a lack of profit motive, if not explainable by circumstances beyond the control of the taxpayer. On the other hand, if there were a profit over several years, this would indicate a profit motive although recently there were losses.
7. Amount of occasional profits, if any. The amount of profit generated over a period of time relative to the amount of losses generated is also a factor to be considered. A substantial profit in one year with comparatively small losses in other years would be a factor indicating a profit motive. Also, a large investment might indicate a profit motive, particularly where there is an opportunity to earn a substantial ultimate profit in a highly speculative venture.

8. Financial status. Lack of substantial income from other sources is indicative of a profit motive, whereas income from other sources would indicate to the contrary, particularly if there are personal or recreational elements involved.
9. Personal pleasure or recreation. If the activity lacks any appeal other than profits, this would be indicative of a profit motive. The fact that a taxpayer derives personal pleasure from the activity, however, does not necessarily rule out a profit motive if other factors evidence one. A profit motive is not negated because the taxpayer has personal motives for engaging in an activity other than a profit motive. For example, a taxpayer may invest in a business for a child with the intent of helping the child financially, yet still have a profit motive.[18]

III. JUDICIAL ANALYSIS

The requirement that all of the facts and circumstances must be considered in determining whether an activity is engaged in for profit makes this area of the tax law uncertain, leading to frequent litigation. This article reviews several recent tax court cases that considered whether expenditures of the taxpayer in connection with an activity in which the taxpayer was involved were deductible as business expenses.

A. Wilmot

Wilmot v. Commissioner was decided December 22, 2011.[19] The tax year at issue was 2004. The taxpayer had earned an engineering degree and a Ph.D in oceanography. He engaged in oceanographic research at various institutions from 1972 to 1984 and taught graduate level courses. In 1984, he started his own oceanographic consulting business, which was

relatively successful, but became dormant in the 1990's. In 1985, he took a full time job with the National Oceanic and Atmospheric Association (NOAA). In 2001, he began taking photography courses at a local college with the professed intent of starting a photographic business. In 2002, while teaching part time at a university, he began an activity that he characterized as a for-profit business entitled Wilmot Environmental Technology. With respect to this business, he deducted photographic expenses on his tax returns for 2002, 2003 and 2004 (the year in issue). In 2004, he stopped working as an oceanographic consultant. He continued as a full-time employee of NOAA, however, and continued teaching part time. In 2004, the taxpayer took three trips to Europe taking pictures to build a photographic portfolio, which photographers use to seek work. During these trips, he staged photo shoots using models. The photo shoots took place in photo studios and other locations. A studio owner provided equipment, models, makeup artists and photo assistance. In 2006, the taxpayer earned an associate's degree in photography. He continued his photographic activities until at least 2007 while continuing his part-time teaching until 2009. He also continued working for the NOAA until his retirement in 2010. On his 2004 tax return, the taxpayer deducted over $57,000 of photographic expenses on Schedule C, Profit or Loss from a Business. His combined gross income from teaching and consulting for 2004 was about $119,000. He reported no gross income from his photographic activity thereby reducing his gross income by the $57,000 of photographic expenses. The taxpayer put into evidence binders of documents to substantiate his photographic expenses, along with Excel worksheets.

Wilmot claimed that he engaged in the photographic activities for profit based upon the factors set forth in the relevant regulations (noted above) and was thus entitled to

deduct the related expenses. The burden of proving that the taxpayer was not engaged in the photographic business was on the IRS.[20] The IRS asserted that the photo activity was not engaged in for profit and that the related expenses incurred were not deductible.

The Tax Court first observed that to deduct expenses of an activity under Code §162, the taxpayer must engage in the activity continuously and regularly and the primary purpose must be profit. A good faith expectation of profit is sufficient, although it need not be reasonable. In making a determination as to whether there is a profit motive all of the facts and circumstances must be considered. The court then referred to the nine factors contained in the regulations that courts typically consider in determining whether an activity is engaged in for profit.

The court found that the taxpayer did not conduct the photographic activity in a businesslike manner. He did not have a separate bank account or written business plan. The records he kept were solely to substantiate tax deductions, which is insufficient to indicate profit motive.[21] Advertising and promotion efforts were meager relative to what a profitable business would have done. He had neither relevant contacts nor a reputation in the photographic industry. He turned down work that he felt was undesirable, such as weddings. He did not make any significant efforts to make the activity profitable.

The factor concerning the taxpayer's expertise was determined to be neutral. Although the coursework he took gave him extensive knowledge of photographic techniques, he lacked adequate knowledge of the business aspects of photography.[22]

The factor concerning time and effort was also determined to be neutral. Although he spent a considerable amount of time on the photographic activity, this included personal and recreational aspects, which severely detracts from the time factor.

There was no credible testimony or evidence that the photos would appreciate in value and provide him with royalty income, nor that the activity would ultimately be profitable. This factor favored the IRS. A mere expectation of profit without a probative foundation is insufficient to establish a profit motive.[23]

The factor concerning success in turning a profit in similar activities favored the IRS. Although he ran an oceanographic business, the skills developed there were not transferrable to the photographic business. Success in one business is not readily transferable to a different type of business.[24]

The taxpayer's history of profits and losses favored the IRS. The losses generally worsened over a 6-year period from 2002 to 2007. Also, the taxpayer never showed any gross income from the photographic activity.

The factor concerning amount of occasional profits relative to the amount of profits also favored the IRS since the taxpayer never reported any profits. His lack of clients, advertising, reputation, business records and flexibility regarding the type of photographic work he would undertake reflected little hope that he would ever become profitable.

The financial status of the taxpayer also favored the IRS. If he lacked other income, this might have indicated a profit motive. The taxpayer, however, had significant income from his teaching and consulting work so that the losses from the

photographic activity significantly reduced his gross income from those activities.

The court was convinced that the photographic activity had personal and recreational aspects, a factor favoring the IRS. The court found it difficult to conceive why the taxpayer would continue an activity that generated no revenue if it were not for the personal and recreational aspects. Moreover, many of his activities involved foreign travel, dining and entertainment.

In conclusion, the court held that the taxpayer did not engage in the photographic activity for profit. He earned no income, incurred increasing losses, did not conduct the activity in a business-like manner, did not keep appropriate records and made no attempt to improve profitability. He had no genuine expectation that his photos would increase in value. He used the losses to offset other income and he derived pleasure from traveling and taking photos. His expertise and time expended did not offset the negative factors against him. Accordingly, none of his expenses for the tax year were held to be deductible under Code §§162 and 183.

B. Oros

Oros v. Commissioner was decided January 5, 2012.[25] The tax year at issue was 2006. During that year, the taxpayer was employed by Intel Corp (Intel). He had a bachelor's degree and master's degree in international business administration. Before 2006, the taxpayer had no experience in writing or publishing a book. In that year, he completed a business plan to write and self-publish a book about a world-wide trip during which he planned to take pictures to be used in the book. The taxpayer was an experienced photographer although not professionally trained. Starting in 2006 and continuing into 2007, the taxpayer travelled to a number of places around the world taking thousands of pictures. He also kept a

contemporaneous journal about his experiences. His trips took about four months during which he took paid vacation time or paid sabbatical leave from Intel.

As of March 2011, the taxpayer had not completed a book about his travels, although he claimed to have written an early draft of about 100 to 150 pages. Neither the draft nor an outline of a book was produced at trial. For 2006, the taxpayer filed a Schedule C with his personal tax return claiming travel expenses of about $17,000 plus other expenses totaling altogether about $19,000. The taxpayer submitted receipts and credit card statements at trial to substantiate his claimed expenses.

The court focused on three factors that it said are relevant in determining whether an activity rises to the level of a business. First, was there a profit motive? Second, was the taxpayer regularly and actively involved in the activity? Third, had the activity actually commenced? The court differentiated between activities engaged in over a long period of time as compared with a one-time venture. Writing can be a business even if not the taxpayer's sole activity. There must, however, be an intent and effort to continue writing for the purpose of producing income and a livelihood for writing to qualify as a business.[26]

Some of the taxpayer's efforts suggested a business. He had a business plan, took thousands of pictures, kept a journal and arranged his itinerary based on photographs he wanted to take for use in his book. Also, the IRS did not question his claimed profit motive. However, he produced no evidence of continued efforts as an author. Further, since the taxpayer was a full-time employee of Intel, writing was not his sole or even primary source of income, which if it were would be a factor in his favor. Accordingly, the taxpayer's writing effort can be seen

as an isolated venture for the personal satisfaction of taking a world-wide tour and seeing his adventures in print.[27] In conclusion, the court found that the taxpayer failed to meet the burden of proof that his writing activities qualified as a trade or business under Code § 162.

The court also noted that even if the taxpayer's travel expenses qualified as a trade or business, he would still not be able to deduct them since he failed to meet the enhanced substantiation expenses relevant to travel expenses.[28] The court favored the taxpayer in one respect. It did not impose a 20% accuracy penalty[29] since the taxpayer consulted a professional tax advisor, provided the necessary information to him and relied on his advice in deducting the expenses.

C. Bronson

Bronson v. Commissioner was also decided in January of 2012.[30] The tax years involved were 2001 through 2005, during which time the IRS assessed tax deficiencies totaling about $149,000. The issue in each of the subject years was whether the horse-related activity of the taxpayers (who filed a joint return) was an activity that was not engaged in for profit within the meaning of Code §183.

Taxpayer Carolyn Bronson (Dr. Bronson) had a Ph.D. in consumer finance. During the years at issue she held a real estate license, but did not work as a broker or otherwise. Taxpayer Peter Bronson (Mr. Bronson) was a practicing attorney specializing in bankruptcy litigation. During the years at issue, he had significant income. The taxpayers have three children. In 1995, they became interested in Welsh ponies and cobs when their only daughter (at the time) began riding lessons on a Welsh pony. They purchased a Welsh pony in that year and Dr. Bronson consulted people who trained and

bred this breed and became involved in breeding organizations. Neither taxpayer had experience with horses in any capacity before 1995. Dr. Bronson had no gainful employment during the years at issue although at some point prior to 2001 she managed a cooperative equestrian barn. During the relevant years, Dr. Bronson devoted substantial time to the horse activity. Mr. Bronson practiced law full time and was less involved.

In 1998, taxpayers purchased another horse and began treating the horse activity as a business, called Coldstream Farm. Although they did not have a written business plan, Dr. Bornson testified that they planned to acquire, breed and train high quality Welsh ponies and cobs. For 1998 and continuing on through at least 2008, the taxpayers reported their horse activity on Schedule C. The losses for the years at issue totaled about $408,000. For the period 1998 through 2008, losses totaled about $838,000. There was never any year where a profit was shown. The only sale during the years at issue was in 2003 when a sale was made for $500 to a non-profit organization. The taxpayers claimed the horse was worth $5,500 and took a charitable deduction of $5,000. Two horse sales were made after the years in issue, both in 2007, one for $6,500 and another for $10,000.

Initially, the taxpayers paid to board their horses. In 1999, they determined they needed their own facility to diversify their offerings and control costs. In 2001, Dr. Bronson toured a number of horse farms for the purpose of acquiring one where they could breed, board, train and conduct sales activities. However, it was not until 2005 that they acquired land for their own facility. In the meantime, they continued to acquire horses and others were foaled. By the end of 2003 and through 2005, they owned ten horses. Dr. Bronson spent a significant amount of time researching and looking for an appropriate location for

a horse farm. During the years at issue, however, they submitted only two offers, which were unsuccessful for various reasons. In 2005, they became interested in a 40-acre property, which had a residence but no equine facility. They hired a group of engineers to plan the design and construction of a barn and arenas on the property and ultimately purchased it that year. Construction began in 2005 but the work done by the contractor was substandard. Litigation ensued and the contractor filed for bankruptcy in 2009. The litigation had not concluded by the time of the tax court proceeding.

Dr. Bronson participated in various breeder organizations throughout the horse activity. She also wrote an equestrian column for a local newspaper and conducted a summer riding clinic. She also advertised offering specific horses for sale. Total advertising expenses for the years at issue amounted to about $3,300.

The taxpayers maintained expense records substantiating their deductions. The records were sufficient for their accountant to prepare their tax returns although the accountant had no expertise regarding horses. There was no evidence that the taxpayers sought his advice concerning whether the deductions taken were subject to restriction under Code §183.

As mentioned, the taxpayers never reported a profit from the horse activity. The losses during the years at issue offset Mr. Bronson's substantial earnings in those years and in most of the follow on years.[31] The IRS disallowed all of the horse activity expenses and imposed the 20% accuracy penalty.

The court first reviewed Code §183 and the applicable regulations stating that to be deductible expenses of an activity must be incurred with the predominant motive of making a profit, except to the extent of gross income generated by the

activity where there is no profit motive.[32] Although subjective intent is determinative, that intent must be determined by objective factors and the burden of proof is generally on the taxpayer. The goal must be to realize a profit on the entire operation; that is, not only to become profitable but ultimately to recoup losses previously sustained. Evidence from years subsequent to the years at issue is relevant in this regard.[33] The court then referred to the nine factor test contained in the regulations.

The taxpayer must show that the activity was carried on in a business-like manner. There must be a business plan and, in the case of horse breeding and sales, a consistent and concentrated advertising program, together with a change in operating method to improve profitability.[34] The taxpayers claimed that they met this standard. However, the court noted that the taxpayers did not proceed at any reasonable pace to acquire a facility despite continuing and increasing loses. They did not begin searching for suitable land until 2001, made no acquisition until 2005 and did not start construction until 2006, despite the increasing losses. Moreover, they continued to acquire horses even though they had not acquired a facility, which required that the horses be boarded. A profit motive would have indicated curtailment of horse acquisitions rather than expansion. To the contrary, the continued acquisition of horses without a facility to board them indicated and indifference to the objective of making a profit. Although the taxpayers might have had a business plan, they failed to adhere to it.

The taxpayers' advertising efforts were meager relative to all of the expenses otherwise incurred. Dr. Bronson's participation in breeder organizations and horse shows was determined to be consistent with a hobby as well as a business. Although the taxpayers kept records of their expenditures, the

court found the records insufficient since they did not adequately differentiate between personal components and the horse activity. Furthermore, the taxpayer did not use the records to improve the performance of a losing operation.[35] The court found the taxpayers' record keeping inadequate, concluding they had not conducted the horse activity in a businesslike manner.

As to the expertise of the taxpayers, they had no prior experience in breeding, training, boarding and sale of horses prior to the time they started the horse activity. Dr. Bronson did, however, consult with breeders and managed a cooperative horse barn at one time before 2001. She also became active in breeder organizations and became knowledgeable about Welsh ponies and cobs. Nevertheless, the court found that these activities were consistent with a hobby. The expertise factor was therefore found to be insignificant in determining whether the taxpayers had a profit motive.

The time and effort factor was found to be neutral. Dr. Bronson was not employed during the years at issue and devoted a considerable amount of time to the horse activity. However, the time spent was also consistent with personal and recreational aspects.

There was no evidence that the horses or the land acquired would significantly increase in value. Only two horses were sold, one for $6,500 and the other for $10,000. At the time of trial, the taxpayers had 13 horses. Even assuming each horse was worth $15,000, their total value was a fraction of the approximately $838,000 cumulative losses of the taxpayer reported through 2008. No evidence was submitted regarding potential appreciation on the land acquired. The factor concerning asset appreciation was determined to favor the IRS.

No evidence was produced concerning success in any relevant business. Mr. Bronson had a successful law practice, but his involvement in the horse activity was minimal compared to Dr. Bronson. This factor was held neutral.

The history of income and losses favored the IRS. The taxpayers maintained they had significant losses because they were in the startup phase of the horse activity. Further, they argued the delay in acquiring a facility was due to circumstances beyond their control. The court acknowledged the regulations list drought, disease, fire, theft, weather conditions, depressed market conditions, illness and death as the possible cause of losses. The court determined, however, that the taxpayers' failure to acquire a horse facility for 6 years was not a circumstance beyond their control. The 6-year period was held too long to be a startup phase. The "desultory" effort at acquiring a facility persuaded the court that making a profit was not the "primary" objective of the horse activity.[36] Finally, losses after the years in issue were not abating but were in fact increasing. Overall, the loss history indicated lack of profit motive. The amount of profits relative to losses clearly favored the IRS since the taxpayers never earned a profit from the horse activity.

The taxpayers' financial status also favored the IRS. Mr. Bronson's average annual income for the years at issue was approximately $269,000. Deducting the losses greatly reduced the after-tax cost of the horse activity.

The personal pleasure or recreational factor was held to be neutral. Dr. Bronson was clearly a Welsh pony and cob enthusiast. She was involved in breeder organizations, showed horses and wrote a column. But all of this was found to be consistent with an avid hobby.

In conclusion, the court held that based on all the facts and circumstances the taxpayer lacked an actual and honest objective of making a profit. They took too much time to acquire a facility even though they knew that a facility was necessary for profitability. Their complacency with respect to increasing losses over the years also suggested lack of a profit motive. Even allowing for the most optimistic assumptions regarding the value of the horses, the taxpayers could not recoup the losses over this period. Yet, they were persisting in the horse activity at the time of trial.

To make matters for the taxpayers even worse, the court sustained the imposition of the 20% accuracy penalty for some of the years that was imposed by the IRS for substantial understatement of income tax. The taxpayers could not show that they ever sought or received advice from their accountant concerning whether deducting the expenses of the horse activity was appropriate. Also, Mr. Bronson's education and knowledge as an attorney was also noted.

D. Strode

Strode v. Commissioner was decided January 18, 2012.[37] The tax years at issue were 2005 and 2007, during which the taxpayer, as an attorney, earned a salary of about $137,000 and $139,000, respectively. For 2005, the taxpayer also reported a business loss on his Schedule C form of about $80,000, and for 2007 a loss of about $84,000. These losses were offset against his salary income. The taxpayer listed the principal business on Schedule C as "International Consulting." The case also noted the amount of losses incurred in other years from 2003 through 2008.[38] No revenue was reported either for the years at issue or for any of the other years mentioned in the case. The IRS asserted that the activity the taxpayer reported on his 2005

and 2007 Schedule C was not entered into for profit. Accordingly, it denied the loss deduction for both years.

The court then reviewed §183 and the applicable regulations. It referred to a decision of the relevant Ninth Circuit, *Wolf v. Commissioner*.[39] In that case, the court stated that an activity is engaged in for profit if the taxpayer's " 'predominant, primary or principal objective' was to realize an economic profit independent of tax savings."

The taxpayer did not prepare any business plan, profit or loss statement, balance sheet or break even analysis. The record did not contain any information regarding the type of business conducted. There was no information about similar businesses that were profitable, nor any material reflecting that the taxpayer changed or abandoned unprofitable methods. There was little evidence concerning the taxpayer's expertise in the activity. The taxpayer was a full-time attorney during the years at issue. Accordingly, he did not devote a substantial amount of time and effort to the activity. There was no evidence submitted about asset appreciation. The activity had never been profitable. Rather, it had significant losses over a number of years. The taxpayer had sufficient income from his salary against which to deduct the losses. Insofar as personal recreation or pleasure was concerned, the taxpayer did not testify at trial concerning his personal views about the activity, asserting that he could not spare the time to appear in court due to a legal matter with which he was involved. The activity required regular travel by the taxpayer, which could have been either for business or for pleasure. Overall, the court found the factors in the regulations to be either neutral or in favor of the IRS. Accordingly, the court held that the taxpayer did not engage in the activity for profit and therefore was not entitled to deduct the expenses of the activity. Finally, the court sustained the imposition of the 20% accuracy penalty.

E. Barker

Barker v. Commissioner was decided March 20, 2012.[40] The tax year at issue was 2006. The amount at stake was about $7,600 deducted as business expenses on a Schedule C attached to the taxpayer's tax return; no income was shown. The principal business listed was "Research: Technical."

The taxpayer had a bachelor of science degree in both physics and psychology, a master's degree in physics, psychology and math, and a master's degree in space architecture. At the time of trial, he was half way through a Ph.D. program in geology.

The taxpayer's first job upon graduation in 1992 with the bachelor degrees was with the National Aeronautics and Space Administration (NASA) in the space shuttle program. Five years later, he transferred to the space station program and has been working for NASA continuously in a variety of positions ever since. In 2003, the taxpayer started Mars Advanced Exploration and Development, Inc. (MAXD). That year, he submitted a detailed proposal to a NASA research initiative program seeking about $70,000 to develop a space suit communication system for use on Mars. Later that year, along with other researchers, he submitted a research document dealing with living off the land when people actually landed on Mars as opposed to taking supplies along from Earth. In 2005, he submitted a "white paper" to NASA focused on the communication system. His stated objective was to further familiarize NASA with his project so as to increase his chances of receiving funding if research grants became available. In 2005, the taxpayer in his capacity as president of MAXD applied for a patent on the communication system, which was

denied on the basis that a patent had been issued a year earlier for a similar system.

In 2006, the year at issue, the taxpayer attended the "9th annual International Mars Society Conference" in Washington D.C. (the taxpayer resided in Texas). The four day conference included the latest information on NASA's plans for space exploration including the Mars Orbiter, which was exploring the Red Planet. The taxpayer produced no documentation substantiating his expenses asserting that they were destroyed by water damage in 2008 during a hurricane. Also during 2006, the taxpayer attended a five day conference in Switzerland, which dealt with various aspects of Mars exploration. In 2008, the taxpayer published a design study about a conceptual mission for the exploration and settlement of Mars, which was presented at a Space Conference and Exposition in California. In 2009, MAXD became dormant.

The IRS denied the taxpayer's deductions on Schedule C, which included travel expenses, meals and entertainment, continuing education and printing, all told amounting to about $7,600. The IRS asserted that the taxpayer was not engaged in a trade or business during 2006 and, in any event, failed to substantiate his deductions. The court held that the taxpayer was not engaged in an active trade or business during 2006 and thus found it unnecessary to decide whether the Schedule C expenses were substantiated.

The court reviewed in detail the background of I.R.C. §162 and relevant regulations, which allow a deduction for the ordinary and necessary expenses of carrying on a trade or business, and I.R.C. §183 and relevant regulations, which deny a deduction for the expenses of an activity not engaged in for profit except to the extent of income generated by the activity. The court then focused on the various factors set forth in the

regulations that should be considered in making a determination as to whether a profit motive existed for engaging in the activity. It noted that more weight is accorded to objective factors rather than mere statements of intent.

The taxpayer contended that he: conducted the activity in a business-like manner citing records he maintained (although destroyed in a flood); acquired research and computer equipment; marketed himself and his company; applied for patents; made continuous improvements to prototypes; and actively applied for grants. The court could not comment on the sufficiency of the records due to their destruction. It noted that MAXD applied for one research grant in 2003 and one patent in 2005, both of which were denied. Although there was a "white paper" in 2005 and design study in2008, there was no evidence that the taxpayer engaged in marketing or applied for any grants in 2006. Although the court acknowledged that the taxpayer spent some time working on the Mars communication system, it held that the evidence in the record did not support a finding that the activity was carried on in a business-like manner.

The expertise of the taxpayer in engineering and space exploration was acknowledged, along with his relevant education. His expertise in space technology was held to be a factor supporting a profit motive.

There was insufficient evidence produced relevant to the amount of time the taxpayer spent on the space activity in any year, especially 2006. During that year, the taxpayer held multiple degrees and was working on another one. The only evidence produced related to the conferences he attended in Washington, D.C. and Switzerland. He was not a presenter at either event. The court held that the factor concerning time and effort expended by the taxpayer did not support a profit motive.

Regarding appreciation of assets, the court held it was unclear whether the Mars communication system would appreciate to the extent the taxpayer would generate an overall profit. While the court said that it could speculate, it found that this factor did not support a profit objective.

While the taxpayer demonstrated a successful career in space exploration, the court held that a successful career as an employee did not show an ability to convert an unprofitable business into a profitable one. This factor was held not to support a profit motive.

The history of income or loss also did not reflect a profit motive. The taxpayer never reported any income since beginning the activity in 2003. Since denial of the patent application by MAXD in 2009, the activity was dormant. The factor concerning amount of occasional profit earned also was clearly not in the taxpayer's favor since no sales were ever reported, let alone profits. From 2003 through 2009, expenditures related to the activity totaled about $54,000, primarily for travel, transportation and continuing education courses. But the taxpayer never sought any funding or entered into any sales contracts. The court implied that the expenses incurred were primarily personal. The occasional profit factor clearly did not support a profit motive.

The financial status of the taxpayer likewise did not support a profit motive. The taxpayer had significant wages and was thus able to use the loss in 2006 to offset his wage income.

Finally, the court stated it could not fault the taxpayer's strong passion for Mars exploration and technology. It believed he pursued a "noble cause" that might ultimately

benefit humanity. It noted, however, that "passion is not synonymous with profit motive."

In conclusion, the court held that based upon its analysis of the factors in the regulations, the taxpayer did not operate in 2006 with the intention of making a profit. As an additional item against the taxpayer, the court found that he was not engaged in a trade or business as required under I.R.C. §162 since he never began to function as a "going concern," noting that investigation of a potential business is insufficient to demonstrate that a taxpayer is engaged in a business. [41]

F. Trupp

Trupp v. Commissioner was decided in April, 2012.[42] The tax year at issue was 2005 for which the taxpayer filed a joint return. Although there were several contested matters, the one relevant to this paper was whether the taxpayer, Robin Trupp, could deduct business expenses under Code §162 in the amount of about $72,000 for equestrian-related expenses. He claimed these expenses were incurred as part of his equine industry law marketing campaign.

During the 1970's, the taxpayer was considered for the U.S. Olympic Equestrian Team. He retired from riding shortly before entering law school from which he graduated in 1981, passing the Florida bar the same year. He then began practicing law as a litigator with a law firm. In the mid 1990's his son, Austin Trupp, began riding in equestrian shows at the age of 12. The taxpayer then became president of an equestrian organization for two years and began representing clients in the equine industry. He left the law firm in the late 1990's to develop his own practice. In 2004, he joined another law firm. Most of the fees he earned during 2005 totaling

about$300,000 were attributable to clients in the equine industry.

The taxpayer attended equestrian shows throughout his son's childhood, at least five of which were during 2005. He claimed that he met potential clients at the shows and as a result developed over 40 clients from 1998 to the date of trial who had equine industry legal matters. He did no formal advertising but claimed he relied on word of mouth, especially when his son's name was announced as one of the top ten winners. He asserted that the name Trupp being announced made people think of him, the equine industry attorney. He testified that while at the shows, he did legal work negotiating horse sales or leases and drafting contracts. His legal assistant testified that he often came back from the shows with new clients and between April 2003 and December 2005 had brought in about 35 new clients as a result of attending shows.

In 2005, the taxpayer claimed about $72,000 in deductible business promotion expenses relevant to the equestrian activities. Among other things, this included horse shoes, boarding, feeding, grooming, transportation, housing, lessons and insurance. During 2005, the taxpayer collected about $921,000 in legal fees from equine industry clients. About $875,000 of this amount was from an equine case he had been litigating since 2000 (JES case), and about $43,000 from another equine case (Ashe case) he had been working on prior to joining his current law firm. He had been hired for the JES case due to a personal relationship he had with the client and not because of his son's horse riding activities. He claimed that he was retained for the Ashe case as a result of his son's equestrian events and this case ultimately generated over $500,000 in legal fees. He testified that during 2006, he collected about $237,000 in legal fees from equine industry clients. Of this, about $135,000 was from the JES case and

about $48,000 from the Ashe case. About $53,000 was from other equine industry matters. The IRS argued that the equine expenses were from an activity not engaged in for profit and not deductible under Code §§162 and 183 and the regulations under §183. The taxpayer argued to the contrary.

The taxpayer first asserted that his equestrian activities and legal practice constituted a "single activity" engaged in for profit. In support of this argument, the taxpayer relied on the tax court's 2007 decision in *Topping v. Commissioner.*[43] The taxpayer in *Topping* was an experienced equestrian who formed a company providing interior design services for horse barns and recreational homes. To promote her business and meet clients, she joined an exclusive equestrian club and began riding in events, where her name was announced. She also paid several thousand dollars to reserve a "table" at the events where she would meet potential clients. In *Topping*, the tax court held that Code §183 "did not preclude a deduction because the equestrian and interior design activities constituted a single activity which was profitable in each of the years at issue."

The court observed that multiple activities can be considered one if sufficiently interconnected.[44] Relevant is the degree of organizational and economic interrelationship, the business purpose of combining the activities and their similarity.[45] The IRS will accept this aggregation theory unless artificial or unreasonable.[46] There are numerous factors the courts consider in determining whether aggregation is unreasonable. Some of the relevant ones are: (1) whether the activities were conducted at the same place; (2) whether the activities were formed separately; (3) whether the activities benefited one another; (3) whether one activity was used to advertise the other; (4) whether there was shared management; (5) whether the taxpayer used the same accountant; and (6) the degree to which the activities shared books and records. [47]

In *Topping*, the taxpayer rode in the equestrian events and reserved a table to converse with potential clients. There was also a close organizational and economic relationship between the equestrian and design activities so that they functioned as a single integrated business. Equestrian activities made up over 90% of the client base of her overall profitable business. In contrast, the taxpayer in *Trupp* did not show a sufficient connection between his equestrian activities and his legal practice. Also, the taxpayer did not ride himself and did not reserve a table or otherwise advertise. Although his legal practice income was substantial, most of it was attributable to the JES case where he was hired based on a personal relationship and not because of equestrian activities. This case also predated 2005, the year in issue, as did the Ashe case. Although his legal assistant testified that many new clients were developed through the equestrian activities, no evidence to support this assertion was introduced. Nor was any evidence produced to substantiate that the taxpayer did legal work at the equestrian activities. The court concluded that the taxpayer's characterization of the equestrian and legal practice to be one integrated activity to be unreasonable.

The taxpayer argued that nevertheless, even if the equestrian and legal activities did not constitute one integrated activity, his equestrian activity alone was engaged in for profit under the factors set forth in the regulations. The court then went on to scrutinize the facts relevant to the regulation factors.

The court found that the taxpayer did not carry on the activity in a businesslike manner nor did he maintain accurate books and records that might indicate that the equestrian activity was engaged in for profit. There were no records pertaining to the shows he attended or work performed at them. Although he did submit personal bank statements and credit

cards, there was no indication of the purpose of his expenditures.

The court did find, however, that the taxpayer was an expert in both the legal profession and in equestrian activities. The expertise factor was determined in his favor.

With respect to time and effort, it was not adequately established how much time he spent on equestrian activities except that it was shown that his son attended five events during the year at issue. The court found that the equestrian events had substantial personal and recreational aspects especially since his son was competing. No evidence was produced to show what, if any, legal work was performed at the events.

The factor concerning possible asset appreciation was held not applicable since the taxpayer did not own any horses. Also, the factor concerning success in carrying on other activities for a profit was held inapplicable. The taxpayer was not able to show that he had brought in business to his law practice by engaging in other activities.

The taxpayer's history of income or loss with respect to the equestrian activity did not favor him since there was no history of income. To the contrary, there were continuing losses. In 2005, the taxpayer earned about $920,000 in legal fees. About $875,000, however, was from the JES case. Even assuming that the rest of his earnings were attributable to the equestrian activities, the related expenses were still about $26,000 more than the earnings. In follow on years, most of his legal practice income was also from JES and Ashe cases. The amount of occasional profits in other years was held to be a neutral factor since the taxpayer did not provide any information for years other than the year in issue.

Insofar as the personal pleasure factor is concerned, the taxpayer had a background as a distinguished equestrian, presumably enjoying attending equestrian events and taking part through his son. This factor therefore favored the IRS.

Considering all the factors adduced at trial, the court concluded that the taxpayer's legal practice and equestrian activities did not constitute a single activity and that the equestrian activity alone was not engaged in for profit. Thus, no deduction for the related expenses was allowed.

G. Solomon Verrett III

In the cases discussed in this article, the taxpayers were engaged in activities that were consistent with those of a hobby because of the element of personal enjoyment. A recent case, *Solomon Verrett III vs. Commissioner,*[48] decided in August of 2012, illustrates, however, that expenses in connection with an activity not commonly thought of as a hobby may nevertheless not be deductible if there is no profit motive. The taxpayer in *Solomon Verrett III* claimed to be involved in a construction activity, which generally would not be thought of as a hobby. The IRS challenged his deductions for 2006, 2007 and 2008. His construction activity never generated a profit and, in fact, the taxpayer had claimed a loss for 17 straight years. He was able to deduct the losses against his wife's substantial income from her medical practice. Applying the nine factor test in the regulations, the Tax Court determined that the taxpayer had no profit motive. The court found that he mostly engaged in non-paying or low-paying jobs for his friends, family and church, and he seemed to derive personal pleasure in helping these parties.

III. CONCLUSION

The foregoing cases clearly illustrate that taxpayers have a tough hurdle to overcome in order to deduct expenses attributable to an activity of a type often engaged in for personal pleasure, achievement or recreation, and which generate little or no revenue. These cases and others flesh out the factors in the regulations by illustrating the intensive factual analysis in which the courts will engage in discerning whether an activity has a profit motive. Although the facts of the cases may differ, there are some underlying themes of which taxpayers and their advisors should be especially heedful. These are failure to conduct the activity in a business-like manor including having a business plan and keeping appropriate business records, generating consistent losses having other income against which to deduct the losses, and the element of personal enjoyment. A tax return reflecting a considerable loss that offsets other income often is enough to alert the IRS and perhaps result in an audit.

The cases may also be viewed as warning taxpayers that if the facts of their activity do not pass muster, it may be wise not to deduct the related expenses. Not only might they be hit with a big tax bill, along with interest, if the deductions are disallowed, but in some cases they may be hit with a 20% accuracy penalty. Most importantly, tax advisors and preparers are under increased scrutiny and regulation. Accordingly, they should be wary of cavalierly preparing a tax return with questionable items in order to please a client or retain one. Is it a business or a hobby? There is an old saying: "If it looks like a duck, swims like a duck, and quacks like a duck, then it probably is a duck."[49]

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[1] New Colonial Ice Company, Inc. v. Commissioner, 292 US 435 (1934).

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[2] Part V, Sections 151-153, contains the rules regarding Deductions For Personal Exemptions; Part VI, Sections 161-199, contains the rules regarding Itemized Deductions For Individuals and Corporations; Part VII, Sections 211-224, contains the rules regarding Additional Itemized Deductions For Individuals; Part VIII, Sections, 241-249, contains the rules regarding Special Deductions for Corporations; Part IX, Sections 261-280H details Items Not Deductible.
[3] Internal Revenue Code (I.R.C.) § 213(a)).
[4] I.R.C. §163(d).
[5] I.R.C. §170(b).
[6] I.R.C. §151(d)(3). The phase out was eliminated in stages as part of the Bush-era tax cuts, which were extended through 2012. If not further extended, however, the phase out on exemptions will resurrect in in 2013.
[7] I.R.C. §162(f).
[8] I.R.C. §162(b).
[9] I.R.C. §183(a) and (b).
[10] I.R.C. §§183(b)(2) and 67(b).
[11] I.R.C. §262.
[12] I.R.C. §263.
[13] I.R.C. §183(b)(1).
[14] I.R.C. §183(b)(2).
[15] Treasury Regulation (Reg.) §1.183-2.
[16] *Id*.
[17] Reg. §1.183-2(b).
[18] The Regulations contain several illustrative examples. *See* Reg. §1.183-2(c).
[19] T.C. Memo. 2011-293.
[20] *See* Shea v. Commissioner, 112 T.C. 183, placing burden of proof on IRS as to new matters not raised in the Notice of Deficiency or in the Answer, and in accordance with the consent of the parties under Rule 41(b).
[21] *See* Bush v. Commissioner, T.C. Memo. 2002-33, *aff'd* (without published opinion) 51 Appx. 422 (4th Cir. 2002).
[22] *See* Golanty v. Commissioner, 72 T.C. 411 (19790, *aff'd* (without published opinion), 647 F.2d 170 (9th Cir. 1981.
[23] *See* Hendricks v. Commissioner, 32 F3d 94 (4th Cir. 1994) *aff'g* T.C. Memo. 1993-396.
[24] *See* Giles v. Commissioner, T.C. Memo. 2005-28.
[25] T.C. Memo. 2012-4.
[26] *See* Wright v. Commissioner, 31 T.C. 1264, *aff'd* 274 F.2d 883 (6th Cir. 1960).

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[27] *See* Hawkins v. Commissioner, T.C. Memo. 1979-101, *aff'd* (without published opinion) 652 F.2d 62 (9th Cir. 1981.
[28] *See* I.R.C. §274(d).
[29] I.R.C. §6662(a).
[30] T.C. Memo. 2012-17.
[31] Apparently due to the relocation of his law practice, Mr. Bronson showed little comparative income in 2006 and a small loss in 2007. However, he had significant income n 2008.
[32] I.R.C. §183(b).
[33] *See* Bessenyev v. Commissioner, 45 T.C. 261.
[34] Golanty v. Commissioner, 72 T.C. 411, *aff'd* (without opinion) 647 F.2d 170 (9th Cir. 1981). (Other citations omitted).
[35] *Id*.
[36] *See* Wolf v. Commissioner, 4 F.3d 709 (9th Cir. 1993) *aff'g* T.C. Memo. 1991-212.
[37] T.C. Memo. 2012-59.
[38] The years at issue were 2005 and 2007. There was no indication in the case as to what happened with respect to the losses incurred in other years.
[39] 4 F.3d 709, (9th Cir. 1993), *aff'g* T.C. Memo. 1991-212.
[40] T.C. Memo. 2012-77.
[41] *See* Richmond Television Corp. v. United States, 345 F.2d 901, (4th Cir. 1965), *also* Dean v. Commissioner, 56 T.C. 895 (1971).
[42] T.C. Memo. 2012-108.
[43] T.C. Memo. 2007-92.
[44] Reg. §1.183-1(d)(2).
[45] *Supra*, Note 43.
[46] *Id*.
[47] Mitchell v. Commissioner, T.C. Memo. 2006-145 (other citations omitted).
[48] TC Memo. 2012-223.
[49] Attributed to various sources.

FOREIGN DIRECT INVESTMENT AND GLOBAL LEGAL STRUCTURES

by

John Paul*

1. INTRODUCTION

Many developed nations often wish that developing nations seek more investment from them. In 2005 and 2007, Germany and the United Kingdom made foreign direct investment to developing nations one of the themes of the G8 Summit. In particular, the United Kingdom wants to increase foreign direct investment (FDI) in developing nations in order to promote the development of these nations and improve the competitiveness of the British firms.[1] In this context, an examination of the global legal structures that affect FDI is necessary.

In general, there are three factors that affect FDI motivations. First is the size and growth possibility of the market. Second is the protection of legal rights (e.g., property rights, contract rights) that affect investment decisions. Third is the availability of resources (e.g., finance, technical skills, and specialized information).[2] Any uncertainty surrounding one or more of these factors can be a major impediment to FDI.

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Uncertainty in many nations can involve large sunk and irreversible costs, causing delays and inefficiencies. These delays and inefficiencies can inhibit the progress of any profit-enhancing and/or poverty-reduction initiatives.[3] This article will examine the history of FDI as well as the legal, economic and political issues associated with it.

2. HISTORY OF FDI

After World War II, international investment gained momentum as foreign investors sought the protection of international investment law found in a structure of scattered treaty provisions, some contested customs and some questionable general principles of law. All of these issues led to a concerted international effort to facilitate the growth of FDI.[4]

2a. Background of the FDI Legal Structure

In the early 1970s, the International Court of Justice in *Barcelona Traction* was surprised that the evolution of global investment law had not progressed further and that no generally accepted rules had been formulated in response to the growth of FDI and the expansion of global activities by corporations in the preceding fifty years.[5] At the time, international law referred to rules generally accepted by municipal legal systems. If a shareholder was injured as a result of an unlawful act committed against that shareholder's corporation, that shareholder could not file a claim against the state. Furthermore, the general rule of international law did not allow any diplomatic protections against a corporation seeking redress against a host nation unless that host nation authorized such protections.[6]

For global investors in this period, the global legal structure was deficient in at least 4 ways:[7] (1) it failed to account for contemporary investment practices and issues;[8] (2) the existing principles were often vague and subject to different interpretations;[9] (3) the content of global investment law was constantly being challenged;[10] and (4) existing global law offered foreign investors no effective enforcement mechanisms to pursue their claims against host nations that had seized their investments and/or violated their contractual obligations.[11]

As a result of these four deficiencies, global investors had no assurance that the investment contracts they made with host nation governments would not be unilaterally changed by those governments at some point in the future. Foreign investments in developing nations were "obsolescing bargains" between the foreign investor and the host nation, as contracts made became subject to renegotiation and even cancellation as time went on.[12]

A famous example of an obsolescing bargain would be the Coca-Cola Company's experience in India during the 1970s. In Round One, Coca-Cola negotiated a deal with the Indian government. Then, in Round Two, Coca-Cola earned visible profits as a result of the deal. Finally, in Round Three, the Indian government demanded that Coca-Cola share its secret formula, something that Coca-Cola didn't even share with the U.S. government. In essence, the original deal negotiated in Round One became obsolete. Coca-Cola was forced to exit at a huge loss.[13] Coca-Cola's experience in India is not unique[14] and this explains why many multinational entities do not want to assume the risk of an obsolescing bargain.

2b. The Treatification Movement

In order to change the dynamics of this struggle and protect the interests of foreign investors, developed nations began to negotiate international investment treaties that would be more clear, complete, uncontestable and enforceable.[15]

The advantage of investment treaties is that they articulate specific standards for investment rights rather than rely on the disputable meaning of substantive rights under customary global law.[16] For example, expropriation is a common custom utilized under customary international law but an investment treaty can offer a foreign investor a guarantee of appropriate compensation for expropriation as well as promises of freedom from discriminatory measures. Basically, investment treaties promise that host nations will not subject foreign investors to inappropriate risks.[17]

The treatification movement bore fruit. In 1959, developed nations concluded bilateral investment treaties (BITs) with specific developing nations in order to protect their investments in those nations by: (1) subjecting host nations to international legal rules that they had to respect and (2) giving investors the right to bring a claim in international arbitration against host nation governments that violated those rules.[18]

By 2005, nearly 2,500 BITs[19] affecting more than 170 nations had been negotiated and other treaties, such as the North American Free Trade Agreement, contained similar investment provisions.[20] By the end of 2006, 177 nations had entered into at least one bilateral investment treaty.[21] As a result, foreign investors around the world are primarily protected by international treaties, rather than by customary international law alone. These treaties have become the main source of international law in the area of FDI. In those cases, where host nation governments have failed to abide by their commitments to foreign investors, these governments have

found themselves as respondents in international arbitration proceedings and have been held liable to pay substantial damage awards to injured foreign investors.[22]

2c. FDI Dispute Settlements

Many investment treaties provide for four dispute settlement processes to which foreign investors have recourse in the event of a conflict with a host nation: (1) the local courts; (2) negotiation; (3) conciliation; and (4) international arbitration.[23]

A significant development in international law has been the growth of Investor-State arbitration to settle investment disputes. From 1987 to 2005, a total of 226 Investor-State treaty arbitrations had been brought and most of them involved private investors as claimants and nations as respondents.[24] This number does not reveal the whole story because it is just an estimate and many of these Investor-State arbitration proceedings are confidential. These arbitrations were brought into institutions such as the International Centre for Settlement of Investment Disputes (an affiliate of the World Bank), the International Chamber of Commerce and the Stockholm Chamber of Commerce.[25] About 65 percent of these 226 cases have been filed since 2002.[26] Investor-State arbitration has become more common and arbitration awards interpreting and applying international investment treaty provisions have become quite numerous.[27]

Prior to the treatification movement, Investor-State arbitration claims were rare and required specific agreements between the investor and the host government to arbitrate disputes arising from investments.[28] Investment treaties have accomplished an open-ended promise to investors by the host nation to arbitrate all claims covered by the treaty provisions.[29]

Investor-State arbitrations are not just simple business disputes that only affect the parties involved. Most Investor-State arbitrations judge the legality of government actions, such as those concerning environmental standards as well as pricing and tax regulations. As a result, Investor-State arbitrations can have a significant impact on sovereign governments' public policies within their own territories; this has led some to characterize these arbitrations as a method of "transnational governance" since an international tribunal is judging the legality of the public policy measures of a specific nation. Even the field of international trade law does not provide similar procedures; violations of trade law are issues resolved only by the nations themselves and the World Trade Organization does not provide remedies to private investors injured by trade law violations.[30]

As an example of how Investor-State arbitrations can have a significant impact on sovereign governments' policies, consider *Chromalloy Aeroservices v. Egypt*.[31] An arbitration tribunal in Egypt awarded damages to an American company for Egypt's breach of a military helicopter maintenance agreement.[32] The award was vacated due to the arbitration tribunal's failure to apply the correct law, a non-waivable ground for annulment in Egypt.[33] Despite this annulment, a U.S. federal court ordered that the award against Egypt's American assets be enforced in an opinion that contained neither precedent nor progeny.[34] What makes this reasoning more controversial is the fact that the Egyptian practice of annulling erroneous awards does not significantly differ from the way U.S. courts vacate awards for improper choice-of-law reasoning.[35]

Investment treaties also grant aggrieved investors the right to prosecute their claims without regard to the concerns and interests of their home nations. This right gives important

significance to international investment contracts because without that right, international investment treaties would be nothing more that mere statements of good will devoid of any legal content.[36]

In practically all Investor-State arbitrations, it is the investor who is the claimant and the host nation that is the respondent. There are two reasons that explain why nations rarely bring arbitration cases against foreign investors: (1) host nations generally believe that their internal legal systems are sufficient to handle their claims against investors in the event of a dispute; and (2) bilateral investment treaties grant rights to investors but rarely impose obligations on them because it is generally believed that a nation has more power than a foreign investor so that these agreements and treaties are drafted against the host nations.[37]

3. GROWTH OF INVESTOR-STATE ARBITRATION

There are at least six reasons for the increased use of Investor-State arbitration: (1) the availability of arbitration as a remedy; (2) the lack of feasible alternatives for aggrieved investors; (3) the politics of Investor-State disputes; (4) the occurrence of major crises; (5) the transformation of the international investment environment; and (6) the development of facilitating factors.

3a. The Availability of Arbitration

The growth of Investor-State arbitration is explained by the increasing number of investment treaties, most of which have been created since the early 1990s. By 2005, there were 2,500 bilateral investment treaties, which led to the creation of a dense bilateral investment treaty network linking about 180 nations.[38] At the end of 2005, the total stock of international

investment was about $11 trillion and involved at least 77,000 multinational corporations as well as their 770,000 affiliates.[39]

The density of this bilateral investment treaty network has increased the negotiation power of foreign investors against host governments. Many of these host governments have never been challenged in a judicial forum of any kind and have objected to being forced to defend their actions in international arbitration proceedings.[40]

These arbitration cases can impose hardships on particular nations, particularly poor developing nations.

First, the host nation may have to pay a substantial damage award, whose amount may be a high percentage of its budget and financial resources.[41] Tribunals have awarded damages of $270 million against the Czech Republic, $71 million against Ecuador, $824 million against Slovakia and $133.2 million against Argentina and these are only a small number of cases.[42]

Second, Investor-State arbitrations can impose policy costs on host nations. In order to advance the public welfare, a host nation adopts certain policy measures. Once an Investor-State arbitration proceeding questions the legality of these policy measures and concludes that they are illegal, the host nation may have to modify or even repeal these measures even if they tend to benefit the host nation as a whole.[43]

3b. The Lack of Alternatives for Aggrieved Investors

An Investor-State arbitration proceeding is expensive, risky and time-consuming and usually destroys whatever business relationship remains with the foreign investor and the host nation. This usually means that the investor will not have access to a dispute settlement process within the borders of the host nation. Many foreign investors have found that they have no better cost effective, reliable alternatives for the settlement

of disputes with the host nation other than Investor-State arbitration.[44]

Besides international arbitration, an aggrieved foreign investor may: (1) accept the host nation's action by absorbing the costs of wrongful action; (2) negotiate a settlement of the dispute with the host nation on its own; (3) mediate the dispute with the assistance of a third party; and (4) access the courts or other legal institutions of the host nation.[45]

3b-1. Accepting the Costs:

Depending on the costs of alleged wrongful host nation action, an investor may decide to absorb the costs of that action or find ways to offset them. The investor basically does a cost-benefit analysis of continuing relations with the host nation government and the local business community. However, while host nation governments may assume that the foreign investor will absorb these losses, there is powerful opposition that may prevent the foreign investor from doing so. The financial stakeholders, such as shareholders, creditors, financing institutions and employees may expect the corporation to maximize profit so that they will receive the benefits. If a host nation government violated an international treaty, corporate management may be obligated to pursue a claim. If the corporate management fails to do so, the stakeholders may feel that corporate management has violated their obligations to them. These stakeholders may decide to file claims against corporate management in the home nation.[46]

Another argument against accepting the loss is that it may encourage other violations in the future. If a foreign investor does nothing in response to a host nation's violation of an international treaty, it may become the victim of more violations in the future by the host nation. Other host nations

may decide to violate international treaties as well. If an international investment treaty is to serve as a check on host nation government behavior, foreign investors must be willing to change that behavior by enforcing their rights under treaty provisions.[47]

3b-2. Negotiation:

Many disputes between foreign investors and host nations are resolved through negotiation and practically all disputes go through a negotiation process before reaching settlement or advancing to Investor-State arbitration.

There are various factors that will determine whether a particular Investor-State negotiation will be successful without the need for Investor-State arbitration. As an example, in 1993, the U.S. Corporation, Enron, and Maharashtra State Electricity Board (MSEB) in India signed a contract whereby Enron and a consortium would build the Dabhol Power Project in a $2 billion investment project and the MSEB would buy the electricity produced from this project over the following 20 years. A new government was elected and cancelled the contract, claiming that the tariff was too high and that the contract was not in the best interests of the government. As a result of negotiations, the contract was modified, the tariff was reduced and the project was continued. A factor that contributed to this result was that Enron was undertaking a number of energy projects in India at the time and felt that it would be more cost-effective to negotiate with the new government rather than engage in a long, protracted struggle through the process of Investor-State arbitration. Enron was open to a negotiated settlement with the host government.[48]

Maharashtra's own reevaluation of the project also led it to become more open to a negotiated settlement. When the Maharashtra government cancelled the power project contract, it assumed that the cancellation would entail little cost. It also assumed that other foreign investors would replace Enron or that it would find other local solutions to its power shortage. These assumptions proved to be inaccurate and when Enron initiated an arbitration case in London with a claim of $300 million, Maharashtra became more open to renegotiating the contract. It does appear that the option of an Investor-State arbitration remedy may encourage more flexibility and create an incentive for host nation governments to negotiate a settlement.[49]

On the other hand, there are many factors that can prevent the achievement of a negotiated settlement. A host nation's belief that important national interests are at stake, an investor's belief that crucial economic interests must be met, the political environment of the host nation, the inability of the investor to mitigate its losses by alternative means and the appointment of incompetent or overly aggressive negotiators to represent the parties are some of the factors that can inhibit the negotiation process.[50]

Unrealistic expectations of the investor and the host nation are another obstacle to successful negotiations. In many cases of foreign investment projects, deadlines are not met, costs are higher than expected, technical and cash flow problems arise and tempers flare. Often times, one side blames the other when it may not necessarily be the fault of either party. It is important that both the investor and the host nation understand the risks involved with long-term projects so that they can accurately assess the worth of these projects. When the investor overvalues the strength of its arbitration claim and the host nation undervalues the strength of the investor's arbitration

claim, the chance of success for a negotiation diminishes. The failure of attorneys to give their clients an honest and realistic assessment of the strength of their arbitration cases increases the failure rate of the negotiation process.[51]

3b-3. Mediation and Conciliation:

Third persons, called mediators, facilitators or conciliators, can help the parties in a dispute resolve their conflicts. Mediation is an age-old dispute resolution technique that can be found in all societies, from rural villages to large cities. Mediation is basically the intervention of a third person into a dispute in order to help the conflicting parties achieve a shared, voluntary agreement. In general, a mediator is able to help the conflicting parties move towards a dispute resolution because this mediator has the situation skills and resources that the conflicting parties do not possess. The mediator's communication skills, objectivity, training, knowledge, creativity, stature and positive relationships are the key resources needed to help resolve the conflict.[52]

As more companies around the world recognize the disadvantages of arbitration, many are beginning to turn to mediation to resolve commercial disputes. Usually, when a dispute can be quantified, such as the extent of damage to an asset by a partner's action, the parties will engage a mediator such as a global accounting or consulting firm to examine the issue and give an opinion. This opinion is not binding on the parties to the dispute but it does allow them to make a more realistic prediction of what could happen in an arbitration proceeding.[53]

A number of arbitration institutions, such as the International Centre for Settlement of Investment Disputes and the International Chamber of Commerce, offer a service known as conciliation, which is usually governed by a set of rules. In institutional conciliation, a party to a dispute may request conciliation from the institution. If the institution obtains the agreement of the other party to the dispute, it will appoint a conciliator. The conciliator does have broad discretion to conduct the process but will usually invite both parties to state their views of the dispute and prepare a report proposing a settlement. The parties may reject the report and move to arbitration or they may accept it. In a number of cases, they will use the conciliation report as a basis for a negotiated settlement. Conciliation is a form of non-binding arbitration with a predictive function. Its approach is rights-based and affords the parties an independent person's evaluation of their rights and obligations. Conciliators do not usually engage in a problem-solving or relationship-building approach to resolve the dispute between the parties. The process is voluntary and confidential and either party may withdraw from the conciliation at any time.[54]

Public information on the conciliation process is scant since it is a confidential process. One published conciliation account involves the 1984 to 1985 dispute between Tesoro Petroleum and the nation of Trinidad and Tobago. A retired British judge, Lord Wilberforce, acted as the conciliator in this case and helped to resolve a dispute involving a $143 million profit distribution. The conciliation lasted under two years and only cost $11,000.[55] Despite the success of this conciliation, conciliations have not become widely used in resolving Investor-State disputes. By 2006, there were 192 requests for arbitration compared to only 5 requests for conciliation. From 1988 to 1993, there were over 2,000 arbitration cases filed at

the International Chamber of Commerce compared to only 54 requests for conciliation.[56]

The reasons as to why more parties in Investor-State investment disputes have not chosen conciliation as a form of dispute resolution is not clear but it is something that more international organizations should address. The low-cost conciliation process is certainly something that international organizations and governments should consider as an alternative to the long and costly international arbitration process.[57]

3b-4. The Local Courts of the Host Nation:

A final alternative to Investor-State arbitration is the court system of the host nation. Some bilateral investment treaties require recourse to the local courts of the host nation as a preliminary step to arbitration and this may pose a variety of problems for foreign investors. First, local courts may not be independent and objective and they may be subject to the political control of the host nation government, thereby depriving the foreign investor of an impartial forum. Second, even if the court system is independent it may harbor bias toward foreign investors. Third, many local courts may simply not have the expertise to apply complex international law principles to complicated foreign investment projects. Fourth, local courts may have a heavy backlog of cases and inefficient administrative procedures that deny swift justice and make the prospect of any final judicial determination impossible. For these four reasons, many foreign investors do not use the local court system as an alternative to international arbitration.[58]

On the other hand, recourse to the local courts of the host nation may provide some advantages. First, it provides the parties with the option to litigate in a public forum where the

dispute arose as opposed to the more private forum of arbitration. Second, it gives the local courts an incentive to provide independent and impartial adjudication of cases thereby providing more comfort to foreign investors. Third, the courts may evaluate challenges to an arbitration award and/or whether the arbitrator awarded damages in a procedurally correct manner.[59]

Of course, whether access to the local courts proves to be detrimental or beneficial to foreign investors depends on how effective the local legal system is. If the legal system in a host nation is stable, transparent, clear and low in corruption, then the foreign investors will probably benefit from any access to that legal system. On the other hand, if the legal system exercises discretionary powers in an arbitrary fashion or issues inconsistent judicial interpretations, the foreign investor will probably incur high transaction costs from such a system.[60]

3c. The Politics of Investor-State Disputes

There are often political issues at stake in Investor-State disputes in addition to the legal issues. Within host nations, there are often many public and political groups as well as the media that take positions on these disputes and these groups can influence how the host nation government deals with the foreign investor in a dispute. This factor can make it difficult for the host nation government to negotiate a reasonable settlement with a foreign investor if such settlement can be challenged by the political opponents of the government. These political opponents can claim that their own government is selling out to foreign corporations and that such government is corrupt and willing to allow the exploits of foreigners to the detriment of the people. The host nation may deal with these political opponents by prolonging arbitration in Investor-State

disputes because they can blame an unfavorable result on the international arbitrators rather than on themselves.

The political dynamic was at work in the famous "Pyramids Case," in which a group of foreign property developers were in a dispute with the Egyptian government.[61] The dispute involved the construction of a destination resort near the Giza Pyramids. The Egyptian government had approved the project but cancelled it under public pressure. The case lasted over 15 years and a tentative settlement of $10 million was negotiated.[62] When the tentative settlement was presented to the Egyptian Prime Minister for his approval, he asked what other alternatives were available. When he was told that the alternative was for Egypt to continue to prolong the arbitration process, he found that preferable since the negotiated agreement to pay $10 million would open him to attack from his political opponents. Eventually, in 1993 the International Chamber of Commerce arbitration tribunal awarded the foreign property developers $27.6 million plus $5 million in costs, which Egypt challenged in an annulment proceeding. That led to the Egyptian government and the foreign property developers settling the case for $17.5 million, which could have been avoided if Egypt had agreed to a conciliation that would have given the Egyptian Prime Minister the political cover he needed.[63]

3d. The Occurrence of a Major Crisis

Recessions and economic crises instigate lawsuits as various litigants fight over the share of a shrinking financial pie. This holds true for international investment. Major financial crises lead to conflict, which eventually finds its way to the arbitration tribunal.

The crises in Argentina, Russia as well as Asia have all led to an increase in international arbitration cases. As of March

2006, there were 110 arbitration cases at the International Centre for Settlement of Investment Disputes and 36 of them involved Argentina as a respondent. All of these 36 cases arose out of Argentina's financial crisis that began in the early 2000s.[64]

3e. The Development of Facilitating Factors

Investor-State arbitration was once a rare process within the domain of only a few international experts. This has changed. Various factors have developed that encourage recourse to Investor-State arbitration. First, is the growing number of cases and awards, which has received media coverage. This has led to a heightened understanding of the Investor-State arbitration process and an improved ability to predict the results of future cases. The awareness of various global legal principles affirming the protection of foreign investor rights as well as the award of substantial damages have encouraged a move towards international arbitration. Second, the growth of law firms specializing in international arbitration law have provided foreign investors with a significant resource to assist them in deciding whether or not they should arbitrate and then carry out the arbitration process on their behalf. Finally, tribunals and law firms have improved the technology and processes of Investor-State arbitration, thereby facilitating the administration of cases and encouraging other investors to utilize this process.[65]

4. CONCLUSION

As the level of international investment increased in the post-World War II era, foreign investors sought the protections

found in an inadequate and scattered legal forum. As a result, there was a concerted global effort to facilitate the growth of FDI. This led to the treatification of international commercial transactions, which established a more coherent and uniform set of international legal rules as well as an international arbitration process that could be used against host nation governments that violated those rules.

A significant development in international law has been the growth of Investor-State arbitration to settle investment disputes, which not only judges business disputed but the legality of government actions, such as those concerning tax regulations or environmental standards. In practically all Investor-State arbitrations, it is the foreign investor who is the claimant and the host nation that is the respondent. These arbitrations have led to the growing negotiation power of foreign investors and imposed hardships on particular nations, particularly poor developing nations.

While Investor-State arbitration may be expensive, risky and time-consuming, it is often the only means of dispute resolution that a foreign investor has against a host nation. This means that the use of Investor-State arbitration to settle FDI disputes will only increase in the future as it appears to be the only effective means of implementing global legal changes in cases where nations are reluctant to change their own domestic legal structures.

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