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The Two Worlds of Transfer Pricing Policymaking
By Michael C. Durst
Tax Notes, January 24, 2011

Michael Durst, a former director of the IRS advance pricing agreement Program, wrote a piece for Tax Notes in January 2011 looking primarily at the shortcomings of the OECD's dominant approach to dealing with transfer pricing issues, and looks at potential changes which might be politically feasible.

Durst believes that public attention recently directed to transfer pricing issues may have made changes more feasible today than they were in the past.

He criticises the "arm's length" transfer pricing approach defended by the OECD, under which transfer pricing arrangements are supposed to reflect "comparable" prices: that is, the prices of similar transactions in the market between unrelated parties (or, one might say, the going market rate for the transaction.)

This approach, he argues, is "based on a fundamental misunderstanding of practical economics." This is because in many industries and markets, it is not feasible for multinationals to operate businesses that are not integrated: in a situation, for example, where manufacturers and distributors are separately owned, that business could not compete with an integrated multinational. So the "comparable" prices simply don't exist – because all the players in the market are integrated and there is no trade between unrelated parties. He continues:

> There is, therefore, a gaping conceptual hole at the heart of the OECD transfer pricing guidelines, as well as the national rules of the United States and many other countries. This theoretical observation has been borne out by 20 years of practice. I have seldom if ever seen a real-life transfer pricing controversy resolved by anything that could reasonably be viewed as sufficiently close comparables.

A second element of Durst's critique is that transfer pricing rules have become "muddled" by the idea that the arm's length approach requires respect for contracts among commonly controlled entities that shift income into tax havens. As he notes:

> The contracts would not be entered into between unrelated parties acting at arm's length, and there is no hint that the people who first articulated the arm's-length standard, under the auspices of the League of Nations in the 1930s, would have accorded those contracts respect for transfer pricing purposes.

The U.S. government, he adds, is "almost never successful" in constraining the amount of income that is shifted. And he goes further, arguing that under the original consensus from the 1930s, the multinationals would have had to implement a version of formula apportionment (see our main transfer pricing page for a description of this.)

He also cites the important example of business restructurings, where it is impossible to calculate an arm's length price for the transfer of business risks, and which allow "almost unconstrained tax avoidance" to take place.

Efforts by the OECD to tackle these problems have been, as he puts it politely, "ineffective."

In what is almost a call to arms, Durst also notes the strength of the lobby supporting the current arrangements:

> I have frequently observed it at close hand, and I believe it has been influential. The effectiveness of lobbying efforts has been enhanced, I believe, by the absence of any financially interested constituency that might serve as an effective counterweight and therefore as a political force for changes to current laws.

Durst then discusses some of the arguments put forwards in defence of the current set-up. **First**, that the current system has been in place for decades and thus very hard to change – and no alternative system has been stress-tested. **Second,** that because of the potential for dislocation, change should happen only incrementally. **Third,** that instead of root and branch change to the current transfer pricing rules, it would be better to focus on other approaches, such as "controlled foreign corporation" (CFC) rules and other measures.

Durst then makes suggestions as to how the two competing world views might be reconciled.

He suggests that first of all – however desirable wholesale reform may be – it may be best to focus for the time being most strongly on those areas most of concern: intangibles and restructuring, and to address them by CFC rules and other changes.

Next, he argues that the OECD and national policy makers should frankly and publicly address the problems that he outlines, notably the lack of comparables.

The OECD has been showing an “excessive reluctance” to explore the issue, damaging both the quality and the credibility of policy making.

He further argues that greater efforts should be made to consider the so-called “profit split” method to deal with transfer pricing questions. To be effective, such a method should incorporate methods that opponents would label as “formula allocation” methods – something the OECD vigorously opposes. In fact, the formula approach has been demonised so effectively that:

> “it will be necessary for the OECD and others to address critics who believe that invoking the word ‘‘formulary’’ constitutes a rational argument against reform proposals.”

He also argues that whatever their message, non-governmental organisations have a valid role to play in this, and the OECD should actively encourage their participation to counterbalance the weight of the powerful lobbies favouring the current system:

> Business groups enjoy access to the OECD in the form of frequent advisory conferences. To remedy any appearance of excessive identification with business and practitioner groups, the OECD should go further down a path, on which it already has embarked, of ensuring similar access by, and a careful dialogue with, critics of current OECD policies. . . . it is necessary for the OECD itself, in the interests of balanced policymaking, to empower their participation in debate.

Among other things, the OECD should not let accounting and law firms and others co-sponsor public events such as its annual tax conferences.

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