The Two Worlds of Transfer Pricing Policymaking

By Michael C. Durst

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Durst suggests ways in which the controversy over transfer pricing rules might lead to politically feasible improvements in the law. Durst recommends that policymakers acknowledge the deficiencies of transfer pricing rules that depend on the presence of uncontrolled comparables; that despite the limitations of today's transfer pricing rules, policymakers in the United States and other countries seek to address the most immediate issues, such as those arising from intangibles migrations and restructurings, through controlled foreign corporation rules and other antiavoidance legislation rather than by attempting wholesale reform of transfer pricing rules; that in the longer term, transfer pricing rules be globally and fundamentally reformed through reliance on a more practically constructed profit-split method; and that to preserve its credibility and effectiveness as an agency responsible for efforts at global reform, the OECD take concrete steps to clarify that it is independent of taxpayer and practitioner groups.

Despite many years of political and academic discussion concerning transfer pricing policy, substantial disagreement persists. The debate has gained intensity recently, in part as a result of press coverage and publications by some international charitable organizations that portray transfer pricing rules as central to tax avoidance by multinational companies.

The public attention that has been directed at transfer pricing practices may have created an environment in which improvements to the rules are, as a political matter, more feasible than they have been in the past. This article seeks to summarize differing positions that I believe underlay the debate — positions that can be described as amounting to two competing worldviews regarding transfer pricing rules — and suggests policy directions that I believe could lead to a more satisfactory system worldwide.

Arguments for Change

My own views are quite critical of current transfer pricing rules, and are conditioned by my experience in the 1990s as director of the IRS advance pricing agreement program, and subsequent years as a private practitioner. Key elements of my perceptions about transfer pricing, which I and others have discussed over the years,[1] include the following:

> i. The basic tenet of arm's-length transfer pricing — the availability of ''uncontrolled comparables'' for transactions between commonly controlled parties — is based on a fundamental misunderstanding of practical economics. Multinational groups form because in some industries and markets, it is economically infeasible to operate nonintegrated businesses. For example, in large markets, it is not feasible for manufacturers and distributors to be separately owned. That means that for transactions between members of multinational groups — precisely the transactions for which transfer pricing rules are important — the uncontrolled comparables on which the current rules try to depend seldom if ever exist. 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.
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> For me, 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. Although most cases are shielded from public view by privacy concerns, the basic failure of comparables is readily apparent in reported judicial opinions in the United States and abroad. Moreover, it is my experience that the situation in the reported cases does not differ fundamentally

[1]*See, e.g.*, Stanley I. Langbein, ''The Unitary Method and the Myth of Arm's Length,'' *Tax Notes*, Feb. 17, 1986, p. 625; Reuven S. Avi-Yonah, ''The Rise and Fall of Arm's-Length: A Study in the Evolution of U.S. International Taxation,'' 15 *Va. Tax Rev.* 89 (1995); and Durst and Robert E. Culbertson, ''Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today,'' 57 *Tax L. Rev.* 37 (2003).

from the hundreds of cases that do not reach the courtroom. In the unreported cases as well, convincing uncontrolled comparables can rarely if ever be found.

ii. Another basic element of my worldview is that transfer pricing rules have become muddled by the idea that the arm's-length standard requires respect for contracts among commonly controlled entities that purport to switch the rights to income from intangible property, and from the bearing of business risks, to subsidiaries in low- or zero-tax countries. Respecting those contracts permits income to be shifted without a requirement of proportionality between the income that is shifted and the level of observable business activity that is conducted in the low- or zero-tax countries. 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. On the contrary, under the original international consensus as stated in the 1930s, taxpayers would have been required to implement a formulary approach to pricing in similar circumstances (although the formula would have been applied on a transactional rather than entity-wide basis, so that the method would have been similar in some respects to today's profit-split methods).[2]

The successful shifting of income through contracts requires the simultaneous operation of both of the central defects of current transfer pricing laws — namely, the mistaken expectation that uncontrolled comparables can be found, and the misconception that the arm's-length standard implies that income-shifting contracts between commonly controlled parties are to be respected. For example, a license by a U.S. taxpayer of a valuable patent to a shell entity in a zero-tax country might not be problematic if the U.S. parent were paid an arm's-length royalty — but experience has shown that because satisfactory comparables are rarely found, the U.S. government is almost never successful in constraining the amount of income that is shifted.

The same twofold problem has arisen over the past 15 years regarding restructurings. Transfers of risk-bearing to low-tax countries might not be problematic if it were possible with reasonable reliability to determine arm's-length compensation for the transfer of business risks within a commonly owned group of companies. There is, however, no practical (or, for that matter, even theoretical) way to accomplish that task. Hence, restructurings, under the arm's-length standard as it is currently understood, allow almost unconstrained tax avoidance — a level of tax avoidance that is seriously constraining the ability of governments, at least in the United States, to control the level of revenue they raise under the corporate income tax.

In my view, attempts by the OECD to address the topic of intragroup contracts through amendments to the transfer pricing guidelines have been ineffective. Even under the guidelines as revised in July 2010, governments are given no practically implementable basis on which to disregard income-shifting when it is not accompanied by the shifting of corresponding observable business activities. Instead, tax administrations must show factually that the specific contracts are not made on arm's-length terms — a vague test that in the real world of tax administration cannot be practically implemented.[3]

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[2]Mitchell B. Carroll, a U.S. lawyer who led the League of Nations study, wrote, for example:

> If the factory in a given state sells its products to independent purchasers, the income may readily be ascribed to it. If an office in one state purchases from outsiders and sells the same goods, with or without transformation, to outsiders, such income is properly attributable to it. In other words, if the various items of income of an enterprise are analyzed and separately allocated either to the obvious source or to the fiscal domicile of the corporation, there remains perhaps a relatively small balance of income that is derived from the joint activities of establishments in two or more states. If there are no criteria for apportioning that income, e.g., independent factory price or dealer price, or if sales establishments may not be regarded as receiving the goods on consignment and therefore remunerated on a commission basis, there may be occasion to resort to an apportionment formula.

Carroll, "Allocation of Business Income: The Draft Convention of the League of Nations," 34 *Colum. L. Rev*. 473, at 490-491 (1934).

[3]In July 2010 the OECD issued a revision of the guidelines, presumably to address issues that have arisen in practice over the past 15 years. Instead, however, although the guidelines acknowledge the practical difficulties encountered by tax administrations, including the particular difficulties addressed in this article, the revised guidelines continue to offer only broad analyses of issues, in an academic style, with little if any useful guidance for hands-on tax administration. The revised guidelines also remain extraordinarily lengthy, a fact that in itself limits their usefulness.

(Footnote continued on next page.)

iii. It is also my observation that the opportunities for tax avoidance under current transfer pricing rules have, over many years, generated an effective and durable lobbying presence in support of retaining transfer pricing rules in their current form. Although it is impossible to gauge the effectiveness of this lobbying. 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.

Arguments in Support of Current Approaches

The view of the world reflected in the OECD guidelines themselves, and in national transfer pricing rules (such as the U.S. transfer pricing regulations) that follow the guidelines, I believe is quite different. With apologies for the errors that one risks in trying to characterize perceptions that differ from one's own, here is how I perceive the worldview that is reflected in the guidelines:

i. The primary purpose of drafting and amending transfer pricing rules is to facilitate an administratively workable system of tax compliance and enforcement. Despite its theoretical and practical shortcomings, the comparables-based approach has been used in practice for decades around the world, and to amend it fundamentally would entail large transition costs in moving to a new system. Moreover, no alternative system has been stress-tested in practice at the global level, and hence there would be a risk of significant unforeseen costs as practical difficulties with an alternative system are encountered and corrective actions taken.

ii. Because of the risks of substantial changes in transfer pricing rules, change should occur incrementally. Currently, the leading candidate for incremental improvements appears to be greater reliance on income-based methods. Those include profit-split methods, which depend less than other methods on the availability of uncontrolled comparables.

iii. Although difficulties associated with income-shifting through intragroup contracts may be significant, the difficulties do not warrant fundamental changes in transfer pricing principles as currently understood, including the idea that contracts that shift rights to income should be respected. To the extent income-shifting is a problem, the appropriate remedies lie in changes to national controlled foreign corporation laws and other national measures, such as the recent "transfer of functions" legislation in Germany. Addressing intangibles transfers and restructurings through amendments to transfer pricing rules would unnecessarily permit an isolable policy problem to dictate wholesale revisions to a system of transfer pricing rules that should be amended only gradually.

If my characterization of the two competing worldviews is close to accurate, the question to be addressed is how most constructively to reconcile them. A starting point is to acknowledge that both worldviews contain some level of merit — a point that I hope is obvious to the reader. But turning the differences of views into a constructive tension, which will yield policy improvements, will require more than mutual understanding — it will involve compromise among and concrete action by the various parties involved.

Possible Steps Forward

Here are some suggestions for actions that might be taken:

i. I believe it should be accepted that to the extent intangibles transfers and restructurings are yielding unacceptable tax results, national governments should address them by changes to CFC rules and other provisions of national antiavoidance legislation, rather than seeking to remedy them by changes to transfer pricing rules. I believe that the "tail wagging the dog" concern is well founded and that transfer pricing policy generally should be addressed separately from concerns about intangibles migrations and restructurings. I believe that, at least in the United States, those transactions should be subjected to greater legal controls, but that Congress and Treasury should accomplish this objective through means that can be

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A new Chapter 9 of the revised guidelines devotes about 26,000 words — more than twice the number in Samuel Beckett's *Waiting for Godot* (N.Y.: Grove Press, 1954), including stage directions — to the difficulties faced in restructurings, particularly the problems inherent in respecting contracts among legal entities the economic interests of which entirely coincide. The substantive guidance contained in these thousands of words, however, can be boiled down to the statement (see para. 9.12 of the guidelines) that tax authorities may challenge a contractual term "if it is not consistent with the economic substance of the transaction." This kind of vague guidance is almost useless in actual tax administration.

implemented more quickly, and with less complexity, than would be entailed in wholesale transfer pricing changes — however much those changes may be desirable as an overall systemic matter.

If it is indeed possible, through specifically targeted statutes and regulations, to reduce the income-shifting that is possible under current transfer pricing rules, then some of the political weight that is applied against modification of existing rules might be removed. That could permit transfer pricing systems to be evaluated according to the criteria that seem most important: cost of compliance, the cost and effectiveness of enforcement, and prevention of double taxation and double under-taxation.

ii. The OECD and national policymakers should frankly and publicly address the problem of the unavailability of useful comparables. Although some might disagree with that observation, I believe that the OECD guidelines and corresponding national tax rules reflect excessive reluctance to acknowledge — and quantitatively explore — the deficiencies inherent in relying on uncontrolled comparables as a component of arm's-length transfer pricing rules. I believe further that the reluctance to look critically at current rules and practices related to comparables has damaged both the quality and credibility of policymaking. The OECD and individual governments should engage more vigorously in quantitative analysis of the functioning of comparables-based methods around the world, and should make this analysis available to the public.[4]

iii. I believe the OECD and national governments should continue exploring the extent to which greater reliance on profit-split methods can ease both compliance and enforcement within the context of an arm's-length system. To be effective, however, a profit-split method should incorporate elements that opponents will label as formulary. In particular, to be effective, a profit-split based method (i) will need to forgo reliance on comparables data, which are not available in sufficient quality or quantity to be useful; (ii) to permit effective enforcement, will need to involve some uniformity of apportionment keys among taxpayers, rather than permitting each taxpayer to decide on its own profit-split method; and (iii) will need to be prescribed for use whenever significant intangible property or other opportunities for enjoying economic rents appears to be present, rather than being included on a list of methods that a taxpayer might elect.[5] Achieving those objectives will not be easy; in particular, 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. Despite the political difficulties, however, these three objectives have to be achieved if a profit-split approach is to be practically administered.

It will be necessary in drafting a profit-split method to determine whether parties to profit splits should receive credit for contributions to the development of intangibles only if they have performed the functions of research or other forms of development, or whether credit should be given for financial investment regardless of whether the entity making the investment performs the development functions. That question is closely related to that of whether transfer pricing rules should seek to limit the shifting of rights to income by means of intragroup contracts. Addressing this issue satisfactorily may require governments to adopt various measures providing tax incentives for R&D or other activities, if meaningful reform of transfer pricing rules is not to encourage the cross-border migrations of the activities — a point which reinforces, I believe,

[4]A future column will suggest means by which these quantitative analyses might practically be performed while preserving taxpayer privacy.

[5]I believe that the OECD's treatment of profit-split methods in the July 2010 revision to the guidelines, like its treatment of restructurings, falls far short of what is needed to permit administration of the rules in actual practice. The revised guidelines devote approximately 5,000 words to profit-split methods (which the guidelines label "transactional" profit splits, apparently to avoid any implication of an acceptance of a formulary approach), but this lengthy discussion provides only the vaguest guidance to tax authorities in deciding how to choose among the many different ways in which a profit split might be constructed. *See especially* paras. 2.146-2.149 of the revised guidelines. In particular, instead of promoting the development of reasonably uniform and therefore enforceable apportionment keys for common situations, the guidelines instead repeatedly invoke the mantra that methods must be devised to reflect each taxpayer's unique facts and circumstances. That perhaps sounds reasonable in the abstract, but in the context of the needs of actual tax administrators, it is in fact a way of ensuring that the rules cannot be enforced effectively. In practice, the guidelines doom tax administrations to endless wrangling with taxpayers over the unlimited number of different forms that a profit split might take.

the desirability of the relatively gradual (but fundamental) approach to reform that this article suggests.

iv. The recent critical press coverage and advocacy by nongovernmental organizations may or may not be fair, but I think they do reflect the perception of some that the determination of transfer pricing policy has reflected disproportionately the interests of multinational businesses and tax practitioners. The OECD in particular can, and I believe should, address that perception. Historically, there has been great demand on the part of businesses and practitioners for access to discussion with OECD personnel, and as a result 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. Because there is no financial incentive for interest groups critical of current transfer pricing policies to arise, it is necessary for the OECD itself, in the interests of balanced policymaking, to empower their participation in debate.

The OECD also should eliminate the practice of permitting accounting and law firms, and other private-sector groups, to cosponsor public OECD events such as its annual tax conferences. Although there is no reason to think that those sponsorships influence decision-making, they create an appearance of excessive identification with business and practitioner interests, and they should be discontinued. In general, the OECD should actively demonstrate a policy of open discussion and critical reevaluation of its current positions.

I hope these suggestions are constructive. Especially if (i) the political tie between income-shifting opportunities and the design of transfer pricing rules can be reduced, and (ii) reliable data on the functioning of current transfer pricing rules can be gathered and objectively evaluated, transfer pricing laws can be much improved, even within the overall framework of existing rules.

Fiscal Commission's Report Frames Budgetary Debate

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The deficit reduction plan proposed by the co-chairs of President Obama's National Commission on Fiscal Responsibility and Reform, along with the full commission's slightly revised report, met with unexpected bipartisan acceptance. While a majority of the commission members supported the final proposal, it failed to gain the 14 votes needed to bring it before Congress. However, the commission's work has been an unqualified success in elevating the debate to address the increasing and unsustainable federal fiscal deficit.

President Obama's National Commission on Fiscal Responsibility and Reform released its final report on December 1, 2010.[1] On December 3, 11 of the 18 members voted to support the plan, three votes shy of the 14-vote supermajority needed to require a congressional vote on the proposal.

The full commission's report followed the November 10 release of a draft proposal by commission co-chairs Alan Simpson, a former Republican senator from Wyoming, and Erskine Bowles, former chief of staff to President Clinton.[2] The co-chairs surprised everyone by pre-announcing their plan, most likely in a preemptive move intended to frame the debate.

The final report called for $4 trillion in deficit reduction by 2020 through sharp spending cuts and significant tax reforms. As Simpson said, "We have harpooned every whale in the ocean — and some minnows."[3] The plan included six major provisions:

- discretionary spending cuts;
- tax reform options;
- healthcare cost containment;

[1] *Doc 2010-25486*, *2010 TNT 231-35*.
[2] *Doc 2010-24196*, *2010 TNT 218-35*.
[3] Lori Montgomery, "Deficit Panel Leaders Propose Curbs on Social Security, Major Cuts in Spending, Tax Breaks," *The Washington Post*, Nov. 11, 2010.