It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws

by Michael C. Durst

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As one who has spent much of a legal career working in international transfer pricing, in the public and private sectors, I find this article not easy to write. While in government, I took pride, as did those with whom I worked, in doing what seemed feasible to help build and maintain a satisfactory international tax system, and as a private practitioner, I, like many others, have sought to operate in a manner that would reflect well on my profession and my clients. I also have sought to study the history and practical operations of the transfer pricing rules, and to share thoughts through professional and academic publications.

Like others inside and outside government, I have perceived shortcomings in the underpinnings of the transfer pricing laws and have offered suggestions for remedying what seem to be serious defects, while remaining within the overall structure of the current arm's-length system. However, despite many efforts at reform around the world during the 40 years or so in which the current system has played an important international role, governments have never been able to administer the system effectively. Moreover, experience to date is sufficient to demonstrate that the current system is based on faulty assumptions regarding the way multinational business is conducted, so that the system, no matter how hard one seeks to reform it, simply is not capable of functioning acceptably.

The resulting damage has been, and is, substantial. Governments around the world are systematically hobbled in their ability to collect revenues from the corporate tax system. Billions of dollars are wasted annually around the world on governmental enforcement efforts that have little chance of success, and on meeting expensive compliance requirements, including the maintenance of ''contemporaneous documentation,'' which are of little real use in promoting tax compliance. Moreover, as the rules become more and more entrenched in an ''international consensus,'' not only the wealthier industrialized countries but also developing countries face pressure to adopt the system, thereby imposing constraints on the successful developments of their own fiscal systems.

Recently, in response to continued criticism of the international regime, senior staff members of the OECD Committee on Fiscal Affairs, while acknowledging the need for improvement in transfer pricing rules, have taken the view that reform efforts should continue to take place within the constraints of the current system, which is based on the arm's-length standard.[1] Under this system, multinational groups are to divide their incomes for tax purposes, among affiliates in the different countries in which the groups do business, in the same way in which the income ''would be [divided in transactions] made between independent

[1]Kevin A. Bell, ''OECD's Owens Rejects Unitary Idea, Focuses on Making Arm's-Length Work,'' 18 *Tax Mgmt. Transfer Pricing Rep.* 518 (2009); and Kevin A. Bell and Molly Moses, ''Silberztein Defends Arm's-Length Standard, Speaks to Restructuring Project, Other Issues,'' 18 *Tax Mgmt. Transfer Pricing Rep.* 516 (2009).

enterprises.''[2] This means, as a practical matter, that multinational businesses are required every year to engage the services of thousands of accountants, economists, and lawyers (like myself) to judge how they would operate if they consisted of collections of independent companies instead of commonly controlled groups, and that tax authorities each year must engage their own thousands of accountants, economists, and lawyers to judge whether the businesses have conducted their analyses adequately.

In limiting reform efforts to measures that stay within the bounds of the arm's-length standard, OECD officials would reject consideration of a more objective means of dividing taxable income among affiliates that has been in operation for many decades among the U.S. states and the Canadian provinces, and which the European Commission is considering for adoption within the European Union. Under this system, formulary apportionment, taxable income is apportioned among taxing jurisdictions not based on the theoretical judgments of economists and other tax practitioners, but on observable facts such as the extent to which multinational enterprises have incurred costs and generated sales revenues in different jurisdictions.

The apparent intention of the Committee on Fiscal Affairs to foreclose consideration of formulary apportionment is disappointing. My own view, based on years of observation, is that formulary apportionment, while far from perfect, operates much more effectively than transfer pricing under the arm's-length standard, which has proven to be so subjective as to be unenforceable.

While it is presumptuous to speculate about the reasoning of the OECD in excluding consideration of formulary approaches, I suspect that the decision is partly influenced — as my own thinking has been in the past — by a fear that efforts to challenge the arm's-length system head on are doomed to political defeat. Indeed, no one who has worked seriously in transfer pricing over the decades can fail to be impressed by how deeply the arm's-length system is entrenched. Despite my belief in the deficiencies of the arm's-length approach, for example, I have suggested compromise approaches not in a belief that they are optimal, but instead in the belief that half a loaf is better than none.[3]

[2]This is the language used in article 9 of the OECD's model income tax treaty; substantially identical formulations are found in bilateral income tax treaties and national tax rules around the world.

[3]*See* Michael C. Durst and Robert E. Culbertson, ''Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today,'' 57 *Tax L. Rev.* 37 (2003) (suggesting greater use of safe harbors, and clearer articulation of intragroup contracts, to facilitate operation of the transfer pricing system).

The inescapable problem, however, is that the failure of the arm's-length system is not rooted merely in the particular way the system is implemented. The problem lies in the assumption, on which the entire system is based, that the tax results of multinational groups can be evaluated as if they were aggregations of unrelated, independent companies transacting with one another at arm's length. Until that view is finally abandoned and replaced by one that is more attuned to practical realities, the international corporate tax system will remain unadministrable.

Flaws of the Arm's-Length Approach

The history of the international transfer pricing system is complex, and it is not possible to ascribe its development to any single influence or event. In reviewing the historical record, however, it is impossible not to identify as pivotal the congressional deliberations leading to the Revenue Act of 1962 in the United States.[4] Following the end of World War II, U.S. companies, particularly in the pharmaceuticals industry, had quickly developed a highly profitable industry based on valuable patents, and they had established ''base companies'' in jurisdictions such as Switzerland and Puerto Rico to which interests in those patents could be assigned.

Some in Congress apparently believed that the arm's-length principle, which had nominally been in effect in tax treaties for several decades but had been of little practical significance during the prewar period, provided inadequate basis for ensuring that the non-U.S. base companies paid adequate royalties to their U.S. parents. In response to this concern, the House of Representatives approved a measure directing Treasury to devise a transfer pricing system based — at least in part — on a formulary system similar to that in use by the U.S. states, in the House version of what became the 1962 Revenue Act.

The Senate, however, dropped the formulary provision from the act. As ultimately passed, the act did not include a specific transfer pricing measure, but instead, the conference report directed Treasury to devise an approach to the income apportionment question. In 1968 Treasury issued regulations setting forth the first ''modern'' transfer pricing rules under the arm's-length standard, based on searches for ''comparables,'' and detailed factual analyses of both taxpayers and allegedly comparable companies.

Undoubtedly, many factors contributed to the decisions of the Senate to kill the formulary provision, and

[4]This and other developments in the history of the arm's-length standard referred to below are described and documented in Durst and Culbertson, *id.*, at 42-96; and 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).

of Treasury to adopt what might be seen as an aggressively arm's-length approach. It seems clear that at least one motivation of Congress and Treasury was to avoid upsetting the apple cart of a relatively low effective tax rate that had been achieved by U.S. pharmaceutical companies through the use of base companies. The pharmaceutical industry was (and remains) central to the U.S. economy, and the government's preoccupation in 1962 was, as it is today, economic growth. To have subjected the industry to bright-line rules of income apportionment, rather than the murky boundaries of the arm's-length standard, would have risked economically hobbling the U.S. economy at a vulnerable time.

Over the next several decades, as new industries developed that, like the pharmaceutical industry, were centered on high-value, easily licensed intangibles, they too became politically attached to the arm's-length standard. The arm's-length standard was perceived as so important to the after-tax well-being of the most strategic industries in the United States that any alternative was politically unthinkable.

A political Gordian knot was thus created. There may well be solid economic reasons to protect intangibles-intensive industries from the full statutory measure of corporate taxation. I have come to identify strongly with these industries over the years, and I am impressed not only by their role in driving innovation, but also their vulnerability to economic risks. As a result of the decision of 1962, however, the means of effecting this reduction in effective tax rates has been the gradual build-up of a massive system of transfer pricing law that causes far more damage globally than could possibly have been foreseen in the 1960s. Moreover, the system has become so ponderous that it is difficult if not impossible for the public, or even all but specialized tax practitioners, to understand. Difficult though it might be politically, the time has come for a fundamental redesign of the international tax system around income apportionment rules that work better than those now in effect.

Incremental attempts at reform are doomed to failure because the unenforceability of the arm's-length standard derives not from the details of its implementation but from its central premises. First, at the center of the arm's-length transfer pricing system is the idea that income from transactions among members of multinational groups should be benchmarked by the results of comparable transactions among unrelated parties. It requires no sophisticated analysis, however, to recognize that commonly controlled multinational groups arise precisely because there are some transactions that do not occur, on an economically efficient basis, between unrelated parties. Thus, for example, the manufacturing and marketing of expensive consumer durables on a global basis, or the exploitation of valuable intellectual property in such fields as pharmaceuticals, software, and information technology, are far too complex and risky to be accomplished by unaffiliated groups of companies transacting with one another independently. For these reasons, many important industries are dominated, either entirely or almost entirely, by multinational groups of commonly owned companies.[5] In these industries — which are the only industries in which international transfer pricing matters — there typically will be no reasonably close comparables on which transfer pricing compliance and enforcement can be based.

A second fundamental flaw in the arm's-length system, which has become increasingly evident over the past decade, is that by treating different affiliates within the same group as if they were free-standing entities, the system respects the results of written contracts between these related entities. These contracts have no real economic effects, as the same shareholders stand on both sides of them, but they nevertheless are given effect under the arm's-length standard.

Thus, multinational groups generally have been free to enter into internal contracts that shift interests in valuable intangibles to tax haven countries in which taxpayers conduct little if any real business activity. Also, more recently, tax professionals have become adept at designing contracts that treat specified members of commonly controlled groups, typically in low-tax countries, as ''entrepreneurs'' that bear all the business risks of a set of transactions, thereby gaining rights to the lion's share of income, with the activities in higher-tax countries designated under contract as ''limited risk'' distribution or manufacturing attracting relatively little income.[6] Under the arm's-length standard, the question whether contracts among related parties should be respected depends on whether the contracts are similar to those into which unrelated parties might enter — but because the activities of unrelated parties are systematically different from those of commonly controlled groups, there are never any plausibly similar contracts against which to evaluate the contracts among related parties, so as a practical matter, it is impossible for governments to second-guess them.

It is not surprising, then, that real-life transfer pricing examinations, no matter how well conducted, eventually dissolve in confusion and controversy. Anyone

[5]For example, I and others who have worked in international business over the past three decades have seen a great many instances in which multinational companies have acquired previously independent distributors in their larger markets, for the reason that it usually is not efficient for a manufacturer to seek to distribute goods by means of continual negotiations with unrelated distributors in the larger markets.

[6]These developments are sometimes discussed under the rubric of ''restructuring,'' and have been under active discussion within international tax circles in recent years. *See, e.g.*, Kevin A. Bell, ''OECD Delegates Debate How to Price Business Restructurings, Taxpayer Representatives Bemoan Non-Recognition Proposal,'' 18 *Tax Mgmt. Transfer Pricing Rep.* 159 (2009).

who has participated in a transfer pricing controversy, from the standpoint of either the taxpayer or the government, can see vividly that the system does not achieve its intended result of a reasonably clear measure of a company's taxable income according to clearly articulated, and hence practically enforceable, standards. Words and numbers spew forth from both taxpayer and government representatives, but the words and numbers have little connection with economic reality. Controversies are resolved through the exhaustion of both sides, using the grossest forms of compromise, rather than on a standard that can assure reasonably similar results in similar cases. For decades the system in operation has been characterized by chaos.

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The extent of this chaos unfortunately can be fully appreciated only by those who work with the system regularly, but a useful inkling can be seen from the wildly disparate positions of tax agencies and taxpayers when entering into a controversy. For example, in the recently decided U.S. Tax Court case of *Veritas Software Corp. v. Comm'r*, 133 T.C. No. 14 (Dec. 10, 2009),[7] the IRS originally sought to increase the taxpayer's income from a particular transaction by $2.5 billion, whereas the court largely upheld the taxpayer's own income inclusion of only several hundred million dollars. In the recent decision of the Tax Court of Canada in *General Electric Canada, Inc. v. The Queen*, Tax Ct. (Can.), 2006-1385(IT)G (Dec. 4, 2009), the Canadian government sought to disallow deductions of approximately C $130 million, and the court rejected the attempted adjustment in its entirety. In 2006, in a rare case in which the details of an out-of-court settlement in a transfer pricing case have become matters of public record, GlaxoSmithKline settled for $3.1 billion a case in which its potential exposure, based on the stated IRS position, was reported to be $14.5 billion.[8] A system of taxation in which the government and taxpayers, presumably in good faith, can state positions that are this widely disparate does not deserve to be called a ''system'' at all.

These cases, on which information is publicly available, represent just the tip of the iceberg. A great many additional controversies involve taxpayer and government positions that are similarly divergent, but under applicable taxpayer privacy laws are settled out of the public eye, usually in administrative appeals proceedings that, despite the good intentions of all involved, take on the character of negotiations over the sale of a used car of questionable mechanical heritage. The results in different cases cannot be reconciled according to any clear principles.

Recent reform efforts, particularly within the OECD, have sought to address these problems by greater reliance on ''income-based'' transfer pricing methods.[9] Such methods, which have been in use for many years, especially in the United States, do not seek to benchmark prices in particular transactions (for example, a particular license of intangibles) against supposedly comparable prices, but instead seek generally to benchmark the incomes of members of groups against the incomes of arguably similar uncontrolled companies. Thus, for example, the income of a controlled U.S. distributor of a foreign manufacturing group might be benchmarked against the net incomes of uncontrolled distributors of roughly similar products.

As an academic matter, such a method might have some attraction — after all, we learned as undergraduates that returns on capital tend, over the long run, to equilibrate among firms in a competitive economy — but in practice it fails dismally. Because the arguable comparables that can be found are always very approximate, the methods in the applicable rules generate supposed arm's-length ranges that are so wide as to be useless. For example, a typical transfer pricing analysis, conducted according to best practices under the U.S. regulations, might conclude for a given manufacturer that a net operating margin within the range of, say, 2 to 6 percent should be accepted as arm's length. That means, for example, that a net income for tax purposes anywhere between $200 million and $600 million

[7] *Veritas* and *General Electric Canada,* mentioned immediately below, both remain subject to appeal at this writing, so the final outcomes of these cases are not known. Even if their results are overturned on government appeal, however, these cases demonstrate the lack of meaningful guidance available to both taxpayers and governments in seeking to resolve cases on a principled basis under current law. (For the court opinion in *Veritas*, see *Doc 2009-27116* or *2009 WTD 236-42*. For the court opinion in *General Electric Canada*, see *Doc 2009-26729* or *2009 WTD 233-15*.)

[8] Tamu N. Wright, ''Glaxo to Pay $3.4 Billion to Settle Largest Tax Dispute in IRS History,'' 15 *Tax Mgmt. Transfer Pricing Rep.* 335 (2006).

[9] The Committee on Fiscal Affairs has incorporated its suggested reforms in proposed revisions to the OECD transfer pricing guidelines. These proposed revisions are available online at http://www.oecd.org/dataoecd/1/57/43655703.pdf.

should be considered acceptable. Such a wide range is almost meaningless for purposes of effective tax administration.[10]

It might be possible to address the problem of wide ranges by instead establishing income-based rules that incorporate specific income targets instead of ranges. For example, it might be required that controlled distribution entities earn taxable profits of at least X percent of sales, or that controlled manufacturing entities earn a taxable markup of at least Y percent on some specified measure of costs.[11] Such rules, however, would amount to nothing more than a very rudimentary — and dysfunctional — kind of formulary system. In particular, these kinds of rules would require distribution or manufacturing entities to earn specified profits regardless of the profitability of the multinational enterprise as a whole, and such a system would quickly collapse in the face of changing economic conditions. Therefore, greater reliance on profit-based methods such as the comparable profits or transactional net margin methods does not appear to offer a promising route for repairing the arm's-length system.

This conclusion also applies, unfortunately, to profit-split methods, the other group of income-based transfer pricing methods that sometimes are used. In theory, profit-split methods hold promise because they do not rely as heavily as other transfer pricing methods on searches for uncontrolled comparables. In practice, however, profit-split methods cannot yield reasonably objective estimates of related parties' appropriate net incomes.

First, the kind of profit split that is most commonly applied — the residual profit split — in fact relies heavily on searches for uncontrolled comparables for a crucial step in its operation, causing the method to fail for the same reasons as other transfer pricing methods. Some other forms of profit splits skip the step of reliance on searches for comparables, but these kinds of profit splits require that a means of dividing profits among members of a group be designed individually in every case. The methods require virtually endless factual judgments to be made by both taxpayers and tax authorities, and they are not susceptible of reasonable administration or enforcement.

Alternatively, it might be possible to design profit-split formulas for different industry groups that, while not precisely tailored to every taxpayer's circumstances, nevertheless provide sensible results in most instances and have the great advantage of being predictable and understandable by taxpayers and governments alike. But a system based on this kind of profit split is, of course, a formulary system of the kind in use by the U.S. states and Canadian provinces and under consideration by the European Commission. It also is the kind of income apportionment system that, I think, must be accepted as necessary if the international tax system is to function effectively.

The practical costs of the unenforceability of arm's-length transfer pricing rules are enormous.

Governments' Loss of Fiscal Control

Current rules permit those taxpayers positioned to shift income by contract, involving either intangibles ownership or, more recently, risk-shifting, to obtain dramatic reductions in their effective tax rates. The result is to severely limit the effectiveness of the corporate tax as a means of raising revenue. This is not to say that at this time, companies in high-technology industries or other economic sectors should face increases in their effective tax burdens through transfer pricing reform or other means. The problem with current transfer pricing rules, however, is that they distribute tax reductions arbitrarily among different companies, even within the same industries, and the reductions are largely out of the control of the legislative process. The transfer pricing rules should be replaced by a system that raises revenues predictably according to the decisions of legislators; tax reductions for economic growth should be designed under the control of legislators and targeted where they are needed most, rather than distributed largely arbitrarily.

Recently, the ''self-help'' tax reductions available to companies through transfer pricing have received criticism from nongovernmental organizations concerned with prospects for economic growth in the poorer developing countries.[12] These organizations may in some instances overstate the extent to which transfer pricing rules are impairing economic growth in developing countries, but their underlying observation is sound. To the extent developing countries follow the international consensus and adopt arm's-length transfer pricing rules,

[10]Surprisingly, such wide ranges do not appear to have been unforeseen consequences of the applicable rules. The U.S. transfer pricing regulations themselves contain examples in which the arm's-length ranges extend from $19,760 to $34,840, a range of 76 percent based on the lower bound; and from $15,500 to $30,000, a range of 94 percent based on the lower bound. Treas. reg. section 1.482-5(e), examples 1 and 3.

[11]A similar result might be reached by eliminating the practice of accepting a result anywhere within a range of results, and instead insisting that an entity's taxable income be determined at the midpoint of the range.

[12]*See*, *e.g.*, Christian Aid, ''False Profits: Robbing the Poor to Keep the Rich Tax-Free'' (2009), *available at* http://www.christianaid.org.uk/Images/false-profits.pdf; Greenpeace, ''Conning the Congo'' (2008), *available at* http://www.greenpeace.org/raw/content/nederland-old/reports/conning-the-congo.pdf; and Duncan Green, *From Poverty to Power* (Oxfam International: 2008), at 314-317.

their corporate tax systems will be hobbled in unintended and unpredictable ways. The OECD, as the guardian of the international consensus, should design an alternative.

Astronomical Compliance Costs

In a vain attempt to make transfer pricing rules more administrable, governments around the world now require taxpayers to maintain, annually, contemporaneous documentation of their transfer pricing policies. Such documentation typically is voluminous; it contains detailed descriptions of the taxpayer's business, and pages and pages of computer output detailing the financial information of arguably comparable companies. The result of all this paperwork, however, is almost invariably an arm's-length range extending at least 100 to 200 percent above the bottom — a range too wide to be of any real use. Contemporaneous documentation therefore serves to put a thin veneer of scientific method over an analysis that is in fact highly subjective and imprecise — and the cost is enormous. Assuming, very conservatively, that there are 5,000 multinational enterprises in the world that must maintain contemporaneous documentation for use in multiple countries, and that the average annual cost of creating and maintaining such documentation (in internal personnel costs and outside consultants' fees) is the equivalent of $200,000, then annual costs to the worlds' shareholders of maintaining the veneer of respectability for current transfer pricing is the equivalent of about a billion U.S. dollars.[13]

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And this is for documentation alone — billions more are spent annually to perform the elaborate legal and accounting work needed to accomplish shifts of income, contractually, to low-tax jurisdictions. Simply look at the rosters of the large international accounting and law firms, and the many independent economic consultancies involved in transfer pricing, to get an understanding of the costly industry that has been created. And this industry (of which I am a part) inevitably has grown into something of a political force with an interest in retaining current rules. Finally, the costs of government attempts at administering the system, generally futile though they appear to be, must amount to at least hundreds of millions of dollars per year. Overall, the costs of trying to make the arm's-length system work — or even just appear to work — easily reach billions of dollars per year worldwide.

In connection with the subject of compliance and enforcement costs, a word should be said about procedural innovations that are sometimes seen as improving the administrability of the arm's-length system. These include (i) advance pricing agreements by which taxpayers can enter into advance rulings, sometimes with more than one government simultaneously, on transfer pricing matters, and (ii) binding arbitration of transfer pricing issues between governments, under income tax treaties. I have personally been involved in the development of APA rules, and I do think that in some circumstances APAs avoid litigation or other protracted disputes and thereby save valuable resources for taxpayers and governments. As a practical matter, however, APA negotiations often are plagued by the same vagueness of legal standards that besets the arm's-length standard generally; APA negotiations often are protracted, difficult, and expensive; and APAs can address only a tiny fraction of transfer pricing issues that arise in multinational business each year. Similarly, binding arbitration under tax treaties is a positive and cost-saving development; however, arbitration can as a practical matter barely scratch the surface of the great many double tax issues that the arm's-length approach spawns each year. It will be far better to reduce the incidence of double taxation by adopting a formulary approach that governments can use to resolve double taxation disputes in a predictable and uniform manner. Even if the particular formulas used by the different governments involved differ in some respects, there should be fewer axes of negotiation — and hence, quite possibly, greater ease in resolving double taxation issues — than under the arm's-length system. In sum, while APAs and binding arbitration can save costs in some cases, they cannot transform the arm's-length system into one that is practically manageable.

Loss of Respect for the Tax System

The world has in recent years experienced the failure of some fiscal institutions that were supposed to be safeguarding the public interest but instead were captured, to greater or lesser extent, by embedded interest groups pursuing narrower agendas. Although it is unrealistic to expect the general public to gain a detailed understanding of the methods of international corporate taxation, the international movement of income to tax havens is increasingly visible, and I believe the feeling is growing around the world that the international tax system is sacrificing the public interest in favor of embedded beneficiaries. This is, I believe, the source of

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[13]This estimate is not, of course, based on a detailed analysis, and the actual annual costs of compliance are likely to be either higher or lower than this estimate. I believe, however, that the estimate in the text is very conservative, and that actual compliance costs are substantially higher. In any event, the underlying problem is that substantial real resources are being expended on documentation that is of questionable value, at best, for purposes of tax administration.

some of the animus displayed recently by nongovernmental organizations concerned with the situation of developing economies, and I think reaction to this perhaps overstated animus has led in turn to overstatement by those who continue to defend the arm's-length system. My overall — if reluctant — view, after years of practice in this field, is that the critics are fundamentally correct; the current system fails utterly in its public role, the appearances created are unseemly, and the system should be replaced.

The Search for an Alternative System

A fundamental alternative to arm's-length transfer pricing — formulary apportionment — not only has long been available, but it has been in effect for many years among the U.S. states and the Canadian provinces. Many people (including myself) have analyzed in detail the manner in which formulary apportionment could be applied at the international, in addition to state and provincial, levels of taxation.[14] It is clear that an international formulary system would operate only imperfectly, just as formulary apportionment has operated only imperfectly within the United States and Canada. The admitted imperfections of the formulary system, however, are meaningful only in the context of a detailed comparison with those of the arm's-length standard. Because the formulary system, unlike the arm's-length approach, is not based on a flat fallacy — namely that ''comparables'' and ''functional analysis'' can lead to a workable tax system — it seems clear that a formulary system, despite all of its flaws, enters the comparison with a key practical advantage over the arm's-length approach. The formulary system can yield a reasonably clear measure of a company's taxable income in a given jurisdiction, but the arm's-length standard, both in theory and in practice, cannot.

Over the years, the Committee on Fiscal Affairs has steadfastly declined to consider global formulary apportionment as a viable alternative to the arm's-length system, and if anything, this position has recently become more insistent. For example, in recent proposed revisions to the OECD's transfer pricing guidelines, the committee repeats generalizations concerning the arm's-length standard that simply cannot be supported by any fair evaluation of real-life experience. Thus, in a model of understatement, the committee claims, ''A practical difficulty in applying the arm's-length principle is that associated enterprises may engage in transactions that independent enterprises would not undertake.''[15] This would suggest that generally, members of multinational groups function pretty much as would independent enterprises transacting with one another at arm's length, and that departures from this comfortable situation are exceptions rather than the rule. The reality, however, is just the opposite: Multinational groups exist precisely because it is impossible to conduct their businesses other than under common control; members of multinational groups will rarely, if ever, transact business with each other similarly to unrelated parties acting at arm's length. Similarly, the proposed revisions would repeat the statement from the existing guidelines: ''The arm's length principle has . . . been found to work effectively in the vast majority of cases.''[16] While in political environments such as the OECD, people sometimes find themselves saying things they later find they cannot support, it is inconceivable to me that any fair observer of transfer pricing practice over the past 20 years could believe this statement to be correct.

Some have expressed unwillingness to subject formulary approaches to careful practical review based on the view, which seems patently erroneous, that the formulary approach is merely an academic or theoretical construct, and that information on which it can be evaluated practically do not exist. To the contrary, there is probably more practical experience available of formulary systems than of arm's-length systems. Experience with formulary apportionment in the United States and Canada provides a body of detailed factual experience extending over almost a century — far longer than the arm's-length standard has been in widespread and intensive use internationally. Moreover, a wealth of practical work has been done in connection with the European Commission's development of a formulary system; and at least one example of statutory and regulatory language based on a formulary approach has been prepared for evaluation by a practitioner in the United States.[17] There is plenty of practical, detailed material available on which to base a careful look at a possible formulary system.

It is against this background that the Committee on Fiscal Affairs, and particularly its professional staff within the Centre for Tax Policy and Administration, would seem to have an important evaluative role. On

[14]I am sure that my own contributions can be improved upon, and indeed I hope that they will be, but they do suggest that seeking to design an international formulary system is not an utterly hopeless task. I have provided suggested statutory and regulatory language in Michael C. Durst, ''A Statutory Proposal for U.S. Transfer Pricing Reform,'' *Tax Notes Int'l*, June 4, 2007, p. 1041, *Doc 2007-12446*, or *2007 WTD 109-8*; a second version, incorporating some technical refinement, is provided in Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, ''Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split,'' 9 *U. Fla. Tax Rev.* 497, 540-553 (2009).

[15]Proposed revised paragraph 1.11, based on existing paragraph 1.10.

[16]Proposed revised paragraph 1.9, based on existing paragraph 1.8.

[17]*See supra* note 15.

its face, it might seem questionable to look for guidance to the staff of the same multinational organization that, 15 years ago, produced the OECD transfer pricing guidelines, and that continues today to argue that reform efforts should remain within the confines of the arm's-length construct. Despite whatever has happened in the past, however, it remains the case that the committee's staff is:

- experienced and knowledgeable;
- of high professional standing;
- multinational; and
- despite the undeniably political nature of the OECD as an organization, generally permitted to operate in an environment of independence from day-to-day political influence.

Moreover, the staff has the ability to supplement its ranks, as needed, with high-quality consultants from academia or other sources outside the OECD, and from time to time has done so.

The member governments of the Committee on Fiscal Affairs should ask the staff, using whatever independent outside technical assistance is needed, to build a thorough model of a system of formulary apportionment that could replace the arm's-length system.[18] Based on such a model, the staff should then conduct a detailed and vigorous debate, contrasting that model with the arm's-length standard as reflected in the guidelines and the various national bodies of law that incorporate it. The goal of the debate and comparison should be a fresh comparative evaluation of the two systems, conducted in an environment as insulated as possible from political lobbying. Further, the debate should be transparent, with all working papers open to public scrutiny — but only *after* the final product of the evaluation has been released, to provide additional insulation against lobbying.

It is important that the comparison be conducted on a practical level by staff members and consultants familiar with the day-to-day operations of tax administrators and other practitioners. The recommended inquiry therefore should be different from, say, a conference involving the presentation of academic papers. There is a large amount of academic literature on the formulary versus arm's-length question. While academic analysis has provided useful insights regarding both formulary and arm's-length systems, it cannot substitute for practical comparisons of the operations of arm's-length and formulary systems based on realistic and detailed fact patterns, conducted by experienced tax administrators. What is needed is detailed, hard-nosed, and sophisticated staff work illustrating how the two systems compare in operational effectiveness; the results of this staff work then can be made public for scrutiny by academics as well as others.

Key to this effort will be assigning the task of building the formulary model to those who are willing to serve as vigorous advocates on its behalf. Only if that condition is met can a true debate be held, with the outcome unknown until the debate is conducted. It is possible that, as a result of the debate, the staff will have reached sufficient consensus to formulate a recommendation to the governmental representatives who comprise the Committee on Fiscal Affairs.

Alternatively, views of the staff may remain sufficiently divided so that it is not feasible to provide a single staff recommendation. Even in that case, the governmental representatives will have in front of them vigorous defenses of competing views, compiled in insulation from political pressure and compiled according to the high quality expected of OECD staff and consultants. Also, once the staff work is done and public (and inevitably political) debate ensues, the Committee on Fiscal Affairs should ensure that not only business groups, but also nongovernmental organizations that are likely to approach the issues from different perspectives, are given opportunity to participate fully in the discussions.

By insisting that the debate be held under the supervision of its staff, and in an adversarial fashion that is insulated from outside politics, the Committee on Fiscal Affairs would avoid the trap that has affected other recent reviews of the merits of arm's-length and formulary systems, including the debate over the U.S. Treasury white paper in the late 1980s and early 1990s and the ensuing debates over the OECD guidelines ending in 1995. In both these instances, the din of political pressure was deafening. Although formulary approaches were formally given some consideration, their development was forestalled by political pressure before they could be articulated in any detail and compared with the arm's-length approach point by point. The political order of the day was to bury formulary, not to analyze it seriously, much less to praise it.

In particular, the problem with past official and quasi-official reviews of the arm's-length standard was that because of political pressures to reject a formulary system as unworkable, the identification of likely flaws in the operation of a formulary approach — and they are, admittedly, significant — was viewed as sufficient reason to reject adoption of the system as a dangerous ''unknown quantity,'' without considering carefully whether a formulary system might function much more

[18]The European Commission has in recent years been developing a formulary system for possible use in the European Union as part of a proposed system for a common consolidated corporate tax base, and the work done by the commission's staff could assist the Committee on Fiscal Affairs in designing an apportionment model. The commission describes its work online at http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm; *see also* Joann Martens Weiner, *Company Tax Reform in the European Union: Guidance From the United States and Canada on Implementing Formula Apportionment in the EU* (Kluwer: 2005). *See also supra* note 14.

fairly and predictably than the current system. Historically, reviews of formulary versus arm's length were similar in many ways to trials in which judgment was rendered after the indictment was read, before the introduction and serious consideration of the evidence. There is no need, however, for such summary rejection of the formulary model. It should be possible for properly motivated, knowledgeable, and unbiased staff members to build a realistic model of a formulary system at the international level and to compare its coherence and workability point by point with the current regime.

For example, in the past, some have sought to dismiss formulary apportionment peremptorily based on the observation that if countries choose to adopt different formulas, differing, for example, in how heavily sales or payroll factors are measured, a problem of potential double taxation will arise. That certainly is true — but it is also true that huge amounts of double taxation result from the impossibility of conducting satisfying analyses under the arm's-length system. Moreover, under current rules, which provide no clear standards, double taxation disputes between tax administrations can take many years to resolve, if they are resolved at all. Under a formulary system, even if different countries have adopted different formulas, they might develop hybrid formulas to resolve double taxation disputes relatively easily and quickly. Thus, the double taxation problem might actually be less troublesome under formulary apportionment than under the current system. In any event, this question must be looked at closely and the two systems compared carefully and as specifically as possible if a meaningful judgment is to be made.

Similarly, some would seek to dismiss formulary approaches out of hand based on the observation that under formulary systems, disputes arise concerning which business activities should be included in the aggregation of income that is subject to the formula. Indeed, over the years, there have been many such disputes under U.S. state tax laws involving the definition of the unitary group, and such disputes can be troublesome. Similar problems arise, however, every day under arm's-length transfer pricing rules, when it is necessary to determine which of a company's business activities should be taken into account in conducting the functional analysis needed to try to identify appropriate comparables. Indeed, those difficulties arise in nearly every transfer pricing question that tax administrators must address, and there is virtually never a means of resolving the question systematically. It seems to me that the question of which business activities should be included in the analysis is probably far more troubling under the arm's-length approach than under a formulary system. The member governments of the OECD should see this question addressed carefully in an open and politically unbiased debate.

Some have also criticized formulary systems, correctly, on the grounds that including such items as payroll and property within the formula could influence companies' decisions concerning the location of employment and plant construction. For many years, however, U.S. states have addressed this issue by basing their formulas predominantly on the location of sales, rather than employment and plant, and it should be possible to adopt a similar approach internationally. Further along these lines, some critics point — again correctly — to difficulties in determining where sales should be deemed made under a formulary system, for example, in instances of electronic commerce or when sales of intermediate goods are made to be incorporated in products for final sale outside the location of manufacture. On careful comparison, however, such difficulties of factual determination might well be far more tractable than the countless factual uncertainties that arise in virtually every situation under the arm's-length standard.[19]

A practical comparison will make it possible as well to address, in a balanced way, another alleged shortcoming of formulary apportionment. In particular, it sometimes is suggested that formulary apportionment would face serious difficulties of implementation because it would require taxpayers and tax authorities to review not only the financial information of the affiliate of a multinational group located in a particular country, but also other components of the group. It is certainly correct that a formulary approach requires reference to information originating outside a particular taxpayer's jurisdiction, but that does not necessarily mean that the formulary approach raises more difficult information requirements than does the arm's-length approach. Even under the arm's-length approach, taxpayers and tax authorities must look at the activities and results of affiliates in many jurisdictions to apply transfer pricing methods — for example, when applying profit split methods, and when searching around the world for a multinational group's ''internal comparables.'' For these and other reasons, tax authorities already routinely refer to financial results of out-of-country affiliates in performing transfer pricing and other international tax examinations.[20] More generally, it must be remembered that under a formulary system the tax administrator typically does not need to audit the taxpayer's operations in every separate jurisdiction. What is needed instead is to compare the operations in the tax administrator's home jurisdiction against the consolidated financial results of the multinational

[19]My own less than perfect, but I hope still potentially useful, suggestions for addressing the problem of location of sales are contained in Avi-Yonah, Clausing, and Durst, *supra* note 14, at 542-543.

[20]*See, e.g.,* IRC sections 6038A and 6038C, and the regulations thereunder.

group. Multinational groups around the world typically maintain both consolidated and entity-level financial statements on a global basis, and it seems unlikely that moving to a formulary system would impose prohibitive accounting or information-gathering needs.[21] In sum, it seems quite possible that a formulary system would impose fewer, rather than greater, information needs on taxpayers and governments than does the current attempt to divide income based on the arm's-length standard. In any event, the comparison should be made carefully and in detail; the result should not be assumed, in advance, in favor of either approach.

Other defects of formulary apportionment undoubtedly can be pointed out,[22] but it is important to evaluate them practically and comparatively, rather than use them as a reason to dismiss formulary approaches out of hand. Let the battle of arm's-length versus formulary be fought energetically, under the auspices of the Committee on Fiscal Affairs, by respected and committed advocates for both sides. There is more than enough indication of dysfunction in the current system, with serious harm being caused, to justify such a comparative inquiry. The cost of this work will be very small compared with the hundreds of billions of dollars of tax revenue, including that of the poorest countries, at stake, as well as the billions lost each year to excessive costs of compliance and attempted enforcement. This is not an abstract intellectual exercise; if we are in fact operating under a dysfunctional system, it is real people who are ultimately being harmed. Let's get on with the job of resolving this issue with the intention of getting it right. ◆

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[21]In fairness, this might not have been the situation, say, 40 years ago when current policy views relating to apportionment methods were first being formed; at that time, multinational groups had less experience in comprehensive global accounting than they often have today.

[22]As an additional example, those intent on preserving the arm's-length approach point correctly to the need for numerous changes to national tax laws and to tax treaties, and for potentially complex transitional rules, if formulary apportionment is to be implemented. Those concerns, however, could be used to avoid serious consideration of all kinds of tax reforms, no matter what the economic and social advantages of such changes might be. What is needed is to develop a model for the necessary legislative and treaty changes and transitional rules, then consider their cost in light of the advantages that might ensue from replacement of the current system, which surely involves massive administrative difficulty of its own.