Michael Durst is a tax lawyer practicing in Washington, D.C. and served during the mid–1990s as director of the US Internal Revenue Service’s “Advanced Pricing Agreement Program,” the advance ruling program for transfer pricing questions. He is the author of “It’s Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws” (Tax Analysts, January 18, 2010), a scathing attack on the OECD’s arm’s–length transfer pricing rules.

Durst says:

“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 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 more attuned to practical realities, the international corporate tax system will remain unadministrable

………

Multinational groups exist precisely because it is impossible to conduct their business 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 [to the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax
Administrations] 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.” 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.

Durst points out that “incremental attempts at reform [of the OECD’s arm’s-length standard] 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.” He emphasises two main flaws in the OECD’s arm’s-length standard:

“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.

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. 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.

Durst emphasises two main results of the OECD’s arms’-length standard.
First, governments’ loss of fiscal control because the “current rules permit those taxpayers positioned to shift income by contract involving either intangibles ownership or, most 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.”

Second, a loss of respect for the tax system:

“The world has in recent years experienced the failure of some fiscal [financial] institutions that were supposed to be safeguarding the public interest but instead were captured, to greater or lesser extent, by embedded interest groups pursuing narrow 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 or embedded beneficiaries

………
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 Durst article points out the risks to developing countries adopting the OECD’s arm’s-length standard:

“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

……
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.”

Durst refers to the “industry” of large international accounting firms and law firms, and economic consultants as a “political force with an interest in retaining current rules.” He recommends a detailed analysis of the formulary apportionment method, which the OECD has rejected:

“Over the years, the [OECD] 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 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.”

Durst shows respect for the staff of the OECD’s Committee on Fiscal Affairs and suggests that it studies the FA method in detail:

“Despite whatever has happen 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.”