

Historical Evolution on Transfer Pricing and Value Creation

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1. Introduction

The modern world economy is characterized by the unrelenting influence of large companies that often act as drivers of economic development. The intensification of the capital concentration and production diversification process since the late 19th century, against the backdrop of growing competition at all levels of the economy, push companies to look for ways to improve their sustainability while paying serious attention to adapting intra-firm relations and management mechanisms to external challenges.¹

In the context of globalization, the role of international companies with branches in several countries is becoming more and more noticeable. As the degree of concentration and diversification goes up and, consequently, the turnover within a company grows, the question arises as to how to regulate this turnover and what management methods are required to improve the effectiveness of intra-firm transactions. The consolidation of companies, both at the national and global levels, significantly complicates the management process and slows down the speed of decision-making. This, in turn, creates the need for a decentralization of managerial functions, in particular, the delegation of some of them to lower levels of the organizational hierarchy.

In these conditions, a company achieves its goals only by relying on a flexible but rigidly managed in-house mechanism based on an introduced system of intra-company settlements at so-called transfer (reference settlement) prices. Transfer pricing, in the broadest sense, means setting a price for a mutual settlement of accounts between the organizational entities of the same company.

Most modern companies are a combination of separate and relatively independent units that are dedicated to specific functions (such as resource purchases, production, sales, administrative and financial support, etc.). Such units are continually related financially with each other and involved, in particular, in the intra-company turnover of goods, services, or other actions. Price, as a free market economic indicator, is used in this case as an instrument of intra-firm regulation that is, first and foremost, intended for company-wide tasks.

In the growing economic complexity of large companies, there are also many contradictions and conflicts of interest that force them to constantly search for the best forms and methods of incentivizing and motivating both managers and all other employees. A well designed transfer pricing system will enable and empower managers to create a sense of responsibility for the results of both the units under their management and the company as a whole. At the same time, it disciplines the managers and accustoms them to the fact that there are no free services in existence and that high costs will ultimately affect their own well-being.

1 Livia Gonzaga, The Interface between the New Australian Transfer Pricing Regime and the OECD BEPS Report and Action Plan, BULLETIN FOR INTERNATIONAL TAXATION AUGUST 2014.

Group companies are interested in profit making by the group as a whole and not by its individual subsidiaries, so they can apply any prices in transactions between themselves. In this context, transfer pricing can be used to accumulate the group's underlying profits in low-tax jurisdictions and move the group's profits from high-tax jurisdictions, enabling the group to reduce its tax liability and increase the "net profits" of the entire corporate structure. Such profits can then be distributed among the group members (for example, using corporate tools). The use of the transfer pricing for these purposes is considered by relevant states to be contrary to their fiscal interests.² Thus, from a tax perspective, the main idea behind transfer pricing as a method to reduce the group's tax burden is to manipulate the prices of these transactions (understatement, overstatement compared to market prices), to minimize the tax base (usually profits) of one company and accumulate such profits in another company (an associate company, usually enjoying tax conditions that are more favorable) and to ultimately ensure that tax benefits are obtained by the group as a whole.

A survey indicated (EY 2016 survey³) that transfer pricing has entered an era of heightened tax risk and controversy that is driven by the exponential increase in the demand for tax-related transparency.

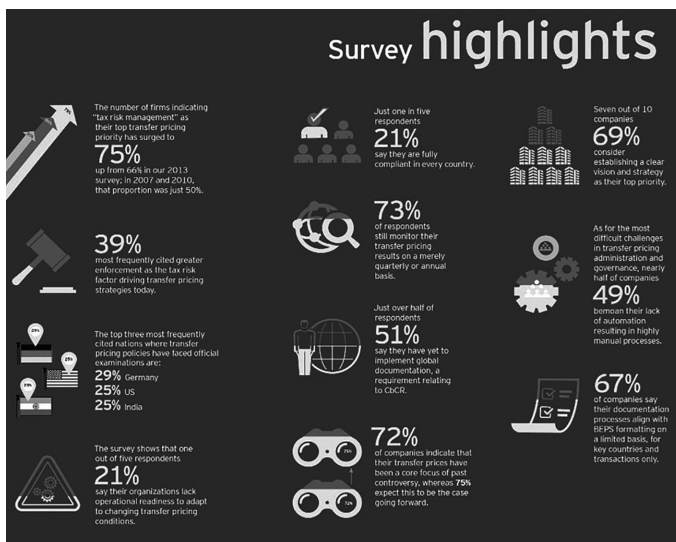


Figure 1: Survey highlights⁴

- 2 A. Zadorozhnaya, History of Institute of tax regulation of transfer pricing, *Peterburgskiy yurist*, 2014, № 3
- 3 EY's 2016-17 Transfer Pricing Survey Series, [Electronic resource] – Access mode: <https://www.ey.com/gl/en/services/tax/ey-2016-transfer-pricing-survey-series>.
- 4 EY's 2016-17 Transfer Pricing Survey Series, [Electronic resource] – Access mode: <https://www.ey.com/gl/en/services/tax/ey-2016-transfer-pricing-survey-series>.

Today, transfer pricing has become one of the most actual and controversial topics in the global tax avoidance debates. In recent years, transfer pricing is under control of the news media, politicians, and different groups that suspect multinational corporations use transfer pricing to pay less than a “fair part” of tax.⁵

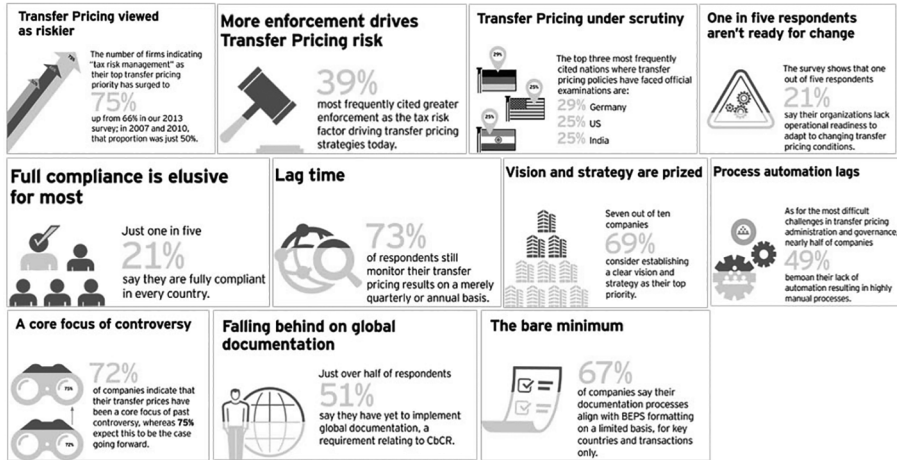


Figure 2: Transfer Pricing⁶

As a result, tax authorities are under pressure to implement greater and unprecedented demands for transparency about multinationals’ operations, tax profiles, and effective tax rates and show tangible outcomes from this.⁷

In addition, the relevance of this research topic is also conditioned by the lack of knowledge regarding the application of transfer pricing in a system of economic relations. By approaching transfer pricing as a tax optimization and avoidance tool, many researchers forget the nature of transfer pricing which emerged as a result of the intensive decentralization process as a way to improve the efficiency of continuously expanding corporations.

All of these factors add extra relevance to the study of transfer pricing as one of the most important elements of the intra-firm mechanism. Therefore, in this thesis, the author has tried to explore the reasons for the historical evolution of ideas of value creation and transfer pricing regulation to see whether its foundations are still relevant in the current global economy.

5 EY’s 2016-17 Transfer Pricing Survey Series, [Electronic resource] – Access mode: <https://www.ey.com/gl/en/services/tax/ey-2016-transfer-pricing-survey-series>.

6 EY’s 2016-17 Transfer Pricing Survey Series, [Electronic resource] – Access mode: <https://www.ey.com/gl/en/services/tax/ey-2016-transfer-pricing-survey-series>.

7 EY’s 2016-17 Transfer Pricing Survey Series, [Electronic resource] – Access mode: <https://www.ey.com/gl/en/services/tax/ey-2016-transfer-pricing-survey-series>.

For example, Lee Sheppard points out that “transfer pricing is the most acute issue among the international taxation problems”.⁸ In the opinion of Hubert Hamaekers, from a financial perspective, transfer pricing is probably the most important tax issue in the world. About 60–70% of all cross-border trade takes place between transnational corporations. However, the term “transnational corporation”, in this case, cannot apply only to the largest of them, such as General Electric, Glaxo, Citigroup, Microsoft, Sony, and Shell, but also applies to all other companies that have one or more subsidiaries or permanent establishments located in another country.⁹ Prof. Lorraine Eden states that “the 21st century is the time when multinational corporations and independent states dominate, with the role of multinational corporations growing increasingly”.¹⁰

The central research question of this chapter is to establish the causes of transfer pricing and the arm’s length standard as a phenomenon and to study the history, introduction, and development of the transfer pricing legal regulations. It will also show how theories of value creation have been transformed over time, adjusting to business development, and what challenges we are facing nowadays in connection with the globalization of digitalization of the economy.

The chapter is composed of four sections. The introduction consists of the main research question, the motivation and the importance of study, and the research methodology. The first section analyzes two kinds of approach: historical development and evolution of theoretical concepts of value creation. The second chapter reviews the transfer pricing rules from the beginning till today, evolution from fiction to reality, and the most important stages of development under international and domestic legislation. The second section also includes a history of the arm’s length principle as well.

2. Historical evolution of the concept of “value creation”

The prime aim of every company is value creation. Each action that the company undertakes is aimed at creating and delivering value in an efficient way to generate profit after cost.

8 Sheppard L. Top U.S. tax expert in savage attack on transfer pricing rules. August 23, [Electronic resource] – Access mode: <http://taxjustice.blogspot.com/2012/08/top-us-tax-expert-in-savage-attack-on.html>.

9 Hamaekers H. Introduction to Transfer Pricing. IBFD Transfer Pricing Database (extract). Introduction to Transfer Pricing. Leiden, International Tax Center Leiden. 2010. P.1.

10 Eden L. The arm’s length standard: making it work in a 21st century world of multinationals and nation states, [Electronic resource] – Access mode: [http://mnccenter.org/sites/default/files/publication_files/The%20Arm's%20Length%20Standard%20\(Lorraine%20Eden%20in%20Pogge%20and%20Mehta,%20Global%20Tax%20Fairness\)-2015.pdf](http://mnccenter.org/sites/default/files/publication_files/The%20Arm's%20Length%20Standard%20(Lorraine%20Eden%20in%20Pogge%20and%20Mehta,%20Global%20Tax%20Fairness)-2015.pdf).

If we assume that Value Creation is the underlying aim of every company, and companies cannot succeed without profit generation, it is an underlying process and concept that needs to be understood.

Generally, value is considered to be the importance, worth, or usefulness of a service or object and the value that is placed upon it by those who wish to take advantage of it. The prime goal of any organization is to create such a product or service, create a demand for such items, and sell them profitably.

In the book, *The Origin of Wealth*, Eric Beinhocker offers a scientifically rigorous definition of the creation of economic value based upon the work of the Economist Georgescu-Roegen:

A pattern of matter, energy, and/or information has economic value if the following three conditions are jointly met:

- 1) **Irreversibility:** All value-creating economic transformations and transactions are thermodynamically irreversible.
- 2) **Entropy:** All value-creating economic transformations and transactions reduce entropy locally within the economic system, while increasing entropy globally.
- 3) **Fitness:** All value-creating economic transformations and transactions produce artifacts and/or actions that are fit for human purposes.¹¹

As we know, value creation is a widely used term.

2.1. Historical development

In the following infographic, the human attempts at creating value are summarized. It depicts the changes in economic evolution up to the present time. Currently, the modern fashion of minimal startups and crowd funding projects appear to be the quickest way to create value/profits and, therefore, the most successful.

This method of creating value is very different from the previous methods available as technology enables entrepreneurs to achieve “Value creation” much faster and more acceptable to the world in general. Previous methods of value creation are listed below:

¹¹ Eric Jorgenson, *Why Value Creation is the Foundation of Business: How to define it, measure it, and manage it.* [Electronic resource] – Access mode: <https://medium.com/evergreen-business-weekly/why-value-creation-is-the-foundation-of-business-how-to-define-it-measure-it-and-manage-it-147c92b87aca>.

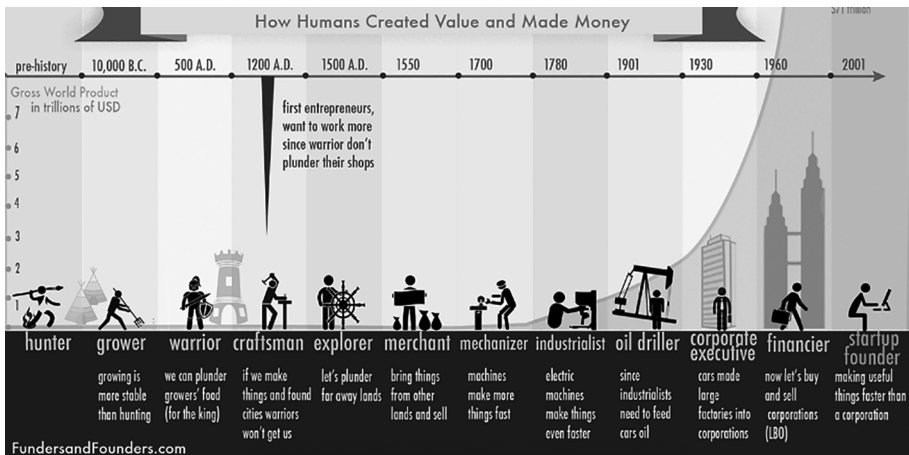


Figure 3: How humans created value and made money¹²

The Hunter Age. The original “Hunter-gathers” relied upon the availability of food items such as animals and naturally occurring crops to feed themselves. As they began to realize that crops could be grown and animals reared in captivity then the evolution into a “growing” society began. However, some tribes found it faster to steal other tribes’ resources than to grow/rear their own. This form of wealth creation produced wars between competing tribes and, ultimately, the acquisition of wealth gaining a bad reputation.

The Warrior Age. Wars were considered to be the way of creating value for kings. Warriors who returned home alive from wars in which they conquered land became vassals to kings and began to own slaves.

The Craftsmen Age. Around the 9th century, some people realized that they could avoid wars by organizing themselves into larger groups. At that time, people had an incentive to work harder and more efficiently, thus evolving into entrepreneurs. Such people, called craftsmen or artisans, were skilled in crafts and created value by making things that were both beautiful and useful.

The Explorer Age. During the late Middle Ages, people were coming up with new ideas and also ventured out into faraway lands from which they returned home with spices, fabrics, jewels, and other riches people had not seen before.

The Merchant Age. Following the discovery of faraway lands and their resources, far thinking entrepreneurs sponsored expeditions to these lands to bring back the exotic goods to sell for a profit. These were the first major companies such as

12 Anna Vital, The History of Creating Value – How Humans Made Money In Different Eras, [Electronic resource] – Access mode: <https://blog.adioma.com/the-history-of-creating-value-infographic/>.

“The Honorable East India Company” (British) and the “United East Indies Company” (Dutch). This was the emergence of the Merchant Class.

The Mechanization Age. Wanting to find ways to improve their products and skills, craftsmen invented new machinery. Machines enabled them to engage in mass production, creating value much faster. The next significant step was to own a machine.

The Industrialization Age. Following the invention of steam power and electricity as well as the electrification of machinery, production started developing at a faster pace, giving rise to the era of industrialists.

The Oil Age. At this time, the demand for fuel started growing. With the advent of the internal combustion engine, greater amounts of carbon-based fuel oils were required and drilling for oil became a necessity. People realized that they could get rich by discovering oil fields. This is when oil companies started appearing.

The Corporate Age. Having motor vehicles, people realized that they could distribute their products to many more consumers. Thus, they organized their companies with many more departments other than just Sales and Production, and created subsidiaries, marking the emergence of corporations. The most powerful position was that of a chief corporate executive.

The Financial Age. With corporations growing bigger and bigger and creating billions in value, banks started buying shares in corporations and reselling them at a profit. Due to the high price of corporations, those having even a small sales margin meant big money. Consequently, banking became the most attractive business.

The Information Age. Corporations employed thousands of people who started spending their earnings or investing them. Banks needed to manage those transactions which started to involve large amounts of information. This gave rise to the information age, with information technology developing at a rapid pace.

The Startup Age. Corporate employees started realizing that, even if working ten times harder, they could not ask for ten times more pay. With the emergence of technology, starting up a company turned out to be not so costly. At this time, a startup founder became the most attractive job.

The above ways of creating value continue to exist. Nowadays, startups create value that demonstrates the highest impact and the highest potential.¹³

Looking at the changes in the way our economy has created value in the past 100 years, we have shifted from a focus on huge mechanical production during the in-

¹³ Anna Vital, *The History of Creating Value – How Humans Made Money In Different Eras*, [Electronic resource] – Access mode: <https://blog.adioma.com/the-history-of-creating-value-infographic/>.

dustrial revolution to production that is more creative and customized through the information age. Software and related services dominate more and more in value creation.¹⁴

Moreover, Jack Hughes points out that

the value of products and services today is based more and more on creativity – the innovative ways that they take advantage of new materials, technologies, and processes. Value creation in the past was a function of economies of industrial scale: mass production and the high efficiency of repeatable tasks. Value creation in the future will be based on economies of creativity: mass customization and the high value of bringing a new product or service improvement to market; the ability to find a solution to a vexing customer problem; or, the way a new product or service is sold and delivered.¹⁵

2.2. Evolution of theoretical concepts of value creation

The theoretical foundations of the notions “value” and “price” play an important role in understanding the entire system of economic relations as well as its particular blocks. Results of economic activities, cash flow, overall costs as well as labor and incentive compensation costs are assessed based on the value’s characteristics. Moreover, the theoretical and methodological foundations of the price serve as a fundamental basis for developing the pricing theory. Price is a fundamental economic category which can be defined as an amount of money for which a seller agrees to sell (selling price) a product/service and a purchaser is ready to buy (purchase price) the same product/service unit.

The notion and essence of commodity value and price have been occupying the attention of scholars and practitioners since the earliest days of organized forms of social life. In particular, the first approaches to determining the intrinsic characteristics of value are noticed in the writings of ancient thinkers and philosophers of China and India.

Both ancient and medieval authors were already distinguishing such characteristics of price as value, cost, and utility. It is these concepts that were significantly developed later in the writings of authors of classical political economy, the marginalist school and their followers.

The basic conceptual approaches to pricing have been progressively evolving, informed by conditions that existed in every specific historical period and the corresponding economic relations.

14 Eric Jorgenson, Why Value Creation is the Foundation of Business: How to define it, measure it, and manage it. [Electronic resource] – Access mode: <https://medium.com/evergreen-business-weekly/why-value-creation-is-the-foundation-of-business-how-to-define-it-measure-it-and-manage-it-147c92b87aca>.

15 Jack Hughes, What Value Creation will look like in the future, Harvard Business Review, May 17, 2013; [Electronic resource] – Access mode: <https://hbr.org/2013/05/what-value-creation-will-look-like-in-the-future>.

Evolution of the approaches to defining the category of “value creation”.

Early Economic Theories. The first landmark in the long intellectual history of creating value was laid by the philosophers of the Athenian Academy in the 4th century BCE. **Aristotle (384–322)** was the first to say that need was the source of value. Without the need, no exchange could take place. He distinguished between use value and exchange value. Aristotle said, “Of everything which we possess, there are two uses; for example a shoe is used for wear and it is used for exchange.” Although his principles were highly progressive, his lack of investigation in this area minimized their significance.¹⁶

Although Aristotle’s views were later adopted by the Scholastics who accommodated them to Christian thought, economics was not yet acknowledged as an independent discipline but only as a part of ethical and moral philosophy. Value was then explained by a normative argument focusing on what value should actually be instead of what it indeed is. During this period, utility was the determinant of value with only a few theorists emphasizing the cost of production.

During the 16th and the first half of the 17th century, early mercantilists were those who explained value in terms of utility. In 1588, a utility theory of value was unsuccessfully constructed by **Bernardo Davanzati** in his “Lecture On Money”. Unsurprisingly, a focus was made on the determinants of the utility (demand for goods) as the merchants’ profits depended on a difference between the market purchase and sale prices and not on the production process control.¹⁷

Pre-Classical Theories. **W. Petty**¹⁸ (1623–1687) is recognized as the first author of the “labor theory of value”. He introduced the concepts of “natural price” (intrinsic value) and “market price”, which maintained that value was determined by labor input. Independently from W. Petty, the labor theory of value was developed by the founder of the French classical economic school, **Pierre Boisguillebert** (1646–1714), who also proposed to measure “true value” by labor inputs. In addition, P. Boisguillebert paid much attention to the study of use value since he believed the purpose of production was consumption.

Nicholas Barbon (1640–1698) believed that the natural value of goods was determined by their market price. He argued that “the value of all wares always arises from their use; things of no use have no value; as the English phrase is, they are good for nothing”. Published in 1690, Barbon’s theory of value is still relevant today. He determined three key postulates of value. First, the natural value of goods

16 Gina Ioan, A Short History of Value Theory, European Integration – Realities and Perspectives. Proceedings 2017.

17 Martin Fogarty, A History of Value Theory. [Electronic resource] – Access mode: https://www.tcd.ie/Economics/assets/pdf/SER/1996/Martin_Fogarty.html.

18 Harry Landreth, David C. Colander, History of Economic Thought, Houghton Mifflin Company Boston Toronto.