Re-Thinking First Principles of Transfer Pricing Rules

John JA Burke
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Abstract

This Article rejects the conventional wisdom that “transfer pricing rules” are designed either to level the playing field between Multi-National Enterprises [MNEs] and medium sized enterprises or to prevent pre-meditated tax evasion by MNEs. Rather, this Article posits that “transfer pricing rules” [TPRs] are substitutes for diminished tariff revenue, or imposed artificial mark-ups, shifting costs to ultimate purchasers, and contradicting the fundamental rule of microeconomic theory of firm maximizing profits by equating marginal cost and marginal revenue. The debate about transfer pricing now centres on tweaking the “arm’s length principle”, safe harbour rules, and advance pricing agreements. Lost in this abyss of profound distraction is the question: why a vertically integrated company that need not obtain a profit at each stage of the production process be treated, counter-factually, like a non-vertically integrated company operating on the open market paying higher prices at each stage of the production process. Further support for the claim against transfer pricing rules is that counter-intuitively, transfer pricing inures to the benefit of the integrated producer by inflating accounting costs and permitting the producer to hide economic profit thereby achieving a result undermining transfer pricing theory and regulation. While this Article recognises that MNE’s may abuse transfer prices, Tax Authorities, in their zeal to augment revenue, fail to distinguish between tax abuse and efficient production methods.

1. Introduction

Transfer pricing, from a financial perspective, “is probably the most important tax issue in the world”. Several developments support this statement. First, most international trade, more than 60%, is conducted within the company group structure of Multi-National Enterprises [MNEs]. Even medium sized companies have subsidiaries or “permanent establishments” in a country other than where the parent company is located. Second, economic drivers, such as location of the production of final products, skilled labour, tax incentives and productions costs, lead companies to engage in cross-border transactions. Third, the emergence of 24 hour trading in commodities and financial instruments has accelerated the pace of globalisation. Fourth, the re-location of intangible property to countries deemed “tax havens” may result in tax abuse. In parallel with these developments, the multi-lateral trading agreements under the auspices of the GATT reduced tariffs and therefore a source of tax revenue collected at the border. The combined effect of these incidents likely explains the phenomenal rise of transfer pricing rules.

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3 Id at 2. The statements that follow are drawn from the manuscript in n 2.
2. The Question

The cross-border provision of goods and services to related entities within a company group underscores the raison d’être of transfer pricing rules. The definition of “transfer price” in business economics is: “the amount charged by one segment of an organisation for a product or service that it supplies to another segment of the same organisation”. An analysis of prices charged for goods and services transferred within a group enable managers to decide whether is it cheaper to buy and sell within the group or on the open market. In the absence of “manipulation” for the deliberate evasion of tax payments, prices of goods and services set at a marginal cost enable a vertically integrated firm to produce a product or service at a price lower than a non-integrated firm. The question that arises is: why defeat a global firm advantage that benefits the ultimate user. Expert consensus states: “If there is a competitive open market for the products and services transferred internally, the best solution from a business economics point of view is to use the market price as a transfer price”. To the contrary, the best solution from a business point of view is to permit vertically integrated multinational firms to maximise integrated profits and confer benefits to the customer base.

3. Brief History of Transfer Pricing Rules

1. The United States

Transfer pricing rules did not “pop out of the blue”. Academics agree that “problems of apportionment” attracted attention at the domestic level within federal systems of government and not at the international level. The United States Congress presumably concerned about “double taxation” of enterprises, enacted legislation to purge this evil on the ground that foreign subsidiaries were established to “milk” the income of U.S. parent companies. In 1921, the United States Congress enacted legislation requiring multinationals to provide consolidated accounting reports “to make an accurate distribution or apportionment of gains, profits, income, deductions, and capital between or among … related business”. In 1928, the United States Congress, reformulating a 1921 law, enacted legislation providing:

“In any case of two or more trades or businesses (whether or not incorporated, whether or not organised in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorised to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such trades or businesses”.

5 The MC envisaged is $MC^*= Va^n$ where V is value and “n” is the number of stages in the production process. MC does not include “mark-ups”. See, discussion infra at p 5.
6 Transfer Pricing: History, State of the Art, Perspectives, supra n 1 at 3.
8 Id.
9 Id.
This language introduces an augmented and novel power. The Commissioner, a state-appointed functionary, has authority to reformulate a company’s consolidated financial statements to make certain that they clearly reflect “the income of any such trade or businesses”. Current Section 482 of the IRS Tax Code “authorises the IRS to adjust the income, deductions, credits, or allowances of commonly controlled taxpayers to prevent the evasion of taxes or to clearly reflect their income”. Section 482 provides that prices charged by one affiliate to another “yield results that are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in the same transaction”. In other words, the price of the transaction should reflect an arm’s length transaction.

The “arm’s length” principle embodies the formulation that “prices set for transactions between related group entities should for tax purposes be derived from prices that would have been applied by unrelated parties in similar transactions under similar conditions in the open market”. Examples of transactions between controlled taxpayers subject to scrutiny by the IRS under Section 428, if they do not reflect an “arm’s length transactions”, include: (1) a loan or advance of money, (2) performance of a service, (3) leasing of property, (4) sale of property, (5) leasing of intangible property, and (6) cost sharing arrangements to develop intangibles.

1. Early International Developments

Transfer pricing regulation did not remain the exclusive province of the United States. “In a multilateral context, the arm’s length principle was formulated for the first time in Article 6 of the League of Nations draft Convention on the Allocation of Profits and Property of International Enterprises in 1936”. The principle also was incorporated in Article VII of the Mexico Draft of 1943, and the London Draft of 1946. A nexus of treaties incorporating “transfer pricing rules” spread widely across the major industrial countries during and following World War Two. The language used to describe the arm’s length principle contained in the present OECD and UN Model tax treaties does not differ substantially from the language used in these predecessor documents.

2. The OECD

Not to be outdone by the United States, the Organisation of Economic Cooperation and Development produced the 1979 OECD Report entitled “Transfer Pricing and Multinational Enterprises.” The 1979 Report has been replaced by the “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations [OECD TP Rules]”. The Model Transfer Pricing Rules published by the Organisation of Economic Cooperation and Development

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11 See, [http://www.usa-international-offshore-company-tax.com](http://www.usa-international-offshore-company-tax.com), last viewed 23 May 2010. The current version of §482 reads: “In any case of two or more organisations, trades, or businesses (whether or not incorporated, whether or not organised in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organisations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary to prevent evasion of taxes or clearly to reflect the income of any such organisations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of 936(h)(3)(B), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible”.


13 See, *State of the Art Practices, supra n 2, 4.*


15 The OECD consists of 30 member countries. Notably absent, however, are some of the largest, and fastest growing countries economic wise, in the world; China, Russia, Brazil, India, Indonesia and South Africa, though they are listed as “enhanced engagement countries”. This raises the question of why the world should take orders from the United States, United Kingdom, and Germany.

[OECD] have attained almost “biblical like” status. The OECD TP Rules ostensibly address two issues: (1) avoidance of double taxation of MNEs operating in diverse tax jurisdictions and the simplification of tax compliance of MNEs with divisions in various jurisdictions, and (2) creation of guidelines for Tax Administrations to tax income accurately in the context of cross-border MNE activity to prevent impediments to cross-border flows of goods, services, and capital. Noting that both residence and source based taxation systems treat each entity with the company group as a separate entity, the OECD adopts the “separate entity approach as the most reasonable means of achieving equitable results and minimising the risk of unrelieved double taxation”.

The separate entity approach leads inexorably to the infamous “arm’s length principle” that treats related entities within a single company group as independent enterprises operating in open markets. The authoritative statement of the arm’s length principle, expressed in the worst sort of legalese, is found in paragraph 1 of Article 9 of the OECD Model Tax Convention provides:

“When conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly”.

But this “arm’s length principle” misses the point by ignoring economic reality the multinational enterprise. The profitability of the MNE is attributable to its organisational form: a group of related entities the architecture of which is designed to benefit from economies of scale and from reduction of transaction costs. The income of an MNE cannot be allocated among the members of the affiliated group in any principled manner.

The OECD TP Rules state:

“These international taxation principles have been chosen by OECD member countries to service the dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimising conflict between tax administrations and promoting international trade and investment. In a global economy, coordination among countries is better placed to achieve these goals than tax competition”.

Ibid at 12.

The rationale follows that set forth in Robert A. Green, The Future of Source-Based Taxation of the Income of Multinational Enterprises, 79 Cornell L. Rev. 18, 46 (1993). Arm’s length pricing is difficult to determine. Hence the US and the OECD adopt a best method approach based on the nature of the intercompany transaction. US regulations, for example, provide for:

1. Comparable Uncontrolled Price Method
2. Comparable Profits Method
3. Profit Split Method
4. Resale Price Method
5. Cost Plus Method

Reflecting the growing importance of the value of intangibles, the IRS and Treasury Department amended the rules in 2004 and continue to revise them.
In applying these principles, the OECD has identified that the most nettlesome issue is the establishment for tax purposes of appropriate transfer prices. “Transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises”.\textsuperscript{19} Transfer prices determine in large part the taxable profits of associated enterprises in different tax jurisdictions.

The salutary goals of the OECD and US Tax Code §482 of double taxation avoidance and cooperative conduct among Tax Administrations mask the underlying reality of the “separate entity approach”. Global firms have the advantage of maximising integrated profit precisely because members of the company group are not independent enterprises and are not required to behave like single entities in the open market. Therefore, transfer pricing rules render illegitimate the production of goods and services at lower prices precisely because of company group structure. The consequence is untenable as demonstrated by the following sets of illustrations.

3. Global Formulary Apportionment

The OECD is aware that the “arm’s length approach” does not track economic reality of integrated company groups. However, it rejects, in absolute terms, one alternative: global formulary apportionment. Global formulary apportionment treats the MNE as a single entity and relies upon the corporate group’s consolidated accounts. Formulary apportionment divides income among tax jurisdictions according to a formula, mainly sales. Global formulary apportionment is not a new concept as it is used in several US states and Canadian provinces.\textsuperscript{20}

The European Union also is considering the adoption of the Common Consolidated Corporate Tax Base permitting allocation of corporate income tax based on a formula. The global formulary apportionment alternative is mentioned here only to “yellow mark” the obstinacy of the OECD and to cut off alternatives to the “arm’s length principle” even though the latter does not work and MNEs waste time and money tax planning around the rules.

4. The Illustration\textsuperscript{21}

The illustration is predicated upon a competitor facing a normal demand curve: \( P = a - bx \), where \( P \) is Price; “\( a \)” is fixed costs, “\( b \)” is variable costs and “\( x \)” is quantity. A firm maximises profit when \( MC = MR \).\textsuperscript{22} Consequently, \( x = \frac{(a-MC)}{2} \) and \( P = \frac{1}{2} \times (a-MC) \). The illustration further presumes that MC is the result of a multi-stage production process. The depiction below demonstrates the difference in MC when the multi-stage production process takes place wholly within a fully vertically integrated firm and a non-integrated firm.

<table>
<thead>
<tr>
<th>Integrated</th>
<th>Nonintegrated</th>
</tr>
</thead>
<tbody>
<tr>
<td>( MC=V ) (No mark-up)</td>
<td>MC=V+M</td>
</tr>
<tr>
<td>( P&lt;MC )</td>
<td>( P=MC )</td>
</tr>
<tr>
<td>AVCC is greater</td>
<td>AVCC is less</td>
</tr>
<tr>
<td>Lower price, greater quantity</td>
<td>Higher price, less quantity</td>
</tr>
<tr>
<td>Comparable higher profits</td>
<td>Comparable lower profits</td>
</tr>
</tbody>
</table>

\textsuperscript{19} Ibid at 13.
\textsuperscript{20} Susan C. Morse, Revisiting Global Formulary Apportionment, 30 Va. Tax Rev ___(2010)
\textsuperscript{21} The illustration is a modification of an unpublished manuscript entitled “Dumping: A Simple Explanation” by Dr. Dana Stevens, KIMEP, Almaty. The manuscript is on file with the author.
\textsuperscript{22} A firm will not produce an additional unit of a good, that is, increase its Marginal Cost unless that increase is lesser than the benefit to be received, that is, Marginal Revenue. A firm adjusts its MC and MR until they are in equilibrium, that is, the firm cannot produce an additional unit of a good without incurring increased costs thereby reducing MR. Robert Cooter and Thomas Ulen, Law & Economics 26-27 [Pearson 5th ed. 2008].
Group of companies are concerned with profit maximization, they maximize profit by setting \( MC = MR \).

\[
X = \frac{(a - MC)}{2b} \quad (1)
\]
\[
P = \frac{1}{2} \times (a + MC) \quad (2)
\]
\[
M = P - V \quad (3)
\]

Suppose \( MC \) is a result of multistage production process. For the final product, 
\[
MC = MC_n = P_{(n-1)} + V_n
\]

“\( M \)” is a sum of the markups, which are “transfer prices”, imposed at each stage of the production process. However, if the producer is vertically integrated, the actual \( MC \) of the final product excludes the mark-ups, or simply \( MC* = V \). The transfer prices are artificially imposed mark-ups distributing final profits to various stages of the production process. These distributions are unrelated to the economic reality of the vertically integrated firms’ profit maximization.

Example:

- **For nonintegrated**

\[
P = 1000 - X
\]
\[
1000 - 2X = M + V
\]
\[
M = 500 \quad V = 100
\]
\[
1000 - 2X = 600
\]
\[
X = 200, \text{ so } P = 1000 - 200 = 800, \text{ Profit} = X \times P = 200 \times 800 = 160,000\]

- **For Integrated**

\[
P = 1000 - X
\]
\[
1000 - 2X = V
\]
\[
M = 500 \quad V = 100
\]
\[
1000 - 2X = 100
\]
\[
X = 450, \text{ P} = 1000 - 450 = 550, \text{ Profit} = X \times P = 450 \times 550 = 247,500\]

**Profit Differential: Integrated and Non-Integrated Firm**

\[
247,500 - 160,000 = 87,500
\]

Under the above illustration, consumers benefit from permanent increase in supplies and lower prices. However, the integrated firm, avoiding mark-ups at each stage of the production process would be accused of a violation of transfer pricing rules under the counter-factual “separate entity approach to intra-group transactions.” In the event, Tax Administrations adjusted the “intra-group” prices to include not only value added \([V_n]\) but also state-mandated transfer prices.

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M₄, then final prices are set on distorted marginal cost, although the integrated firm would lose its MC benefit.

In his unpublished manuscript, Dr. Stevens provides a second illustration in support of his explanation of “dumping”. This illustration may be flipped to apply with equal force to transfer pricing regulation and to an alternative method of taxing entities to achieve economic efficiency. Assume a state owned oil refinery purchases crude oil from a private company that pays income taxes to the state. The extraction cost of crude oil is 50$ and the cost of refinery is 50$, then the un-integrated MC is 600$ [50$ + 500$ + 50$], the 500$ being the mark-up [world market price] of the crude producer. The integrated MC is 100$ [600$ - 500$ mark-up (transfer price)].

Reverting to the formula above²⁴, if profits are maximized using MC = 600$, then 1000-2X, where X is 200, then P = 800 [1000 –X]. Revenue generated equals 160 000$; costs equal 20 000$ [100 (MC) *200 units], yielding a profit of 140 000$. By contrast, if joint profits are maximised, we return to our calculation of selling 450 units at a price of 550$, for a total revenue stream of 247 500$ minus real costs of 45 000$ [100*450], for a total profits of 202,500$, an increase in profits of 62 500$.

However, joint maximisation of profits are achieved if MC* =V: the refinery makes a profit of 40 000$ and does not lose 22 500$ to “transfer pricing”. The crude producer makes a profit of 202 500$ and does not lose 62 500$ to transfer pricing. Pareto efficiency is achieved if the Tax Administration imposes a tax of 62 500$ upon the crude producer and that tax is used to subsidise the refinery. Neither refinery nor the crude producer is worse off. Even if the producer eliminates competition and establishes a monopoly, the monopolist has no incentive to increase prices, absent a change in demand.

In final, an integrated firm may have a lower average cost of capital than a non-integrated firm as the former may be deemed to pose less risk of insolvency. That being true, then the non-integrated firm must fix its mark-up to include its increased cost of borrowing, and demand a higher required rate of return at each stage of the production process. The implicit cost of money in the required rate of return between the integrated and non-integrated firm skews the application of transfer pricing, and provides further support for the lack of logic underpinning transfer pricing rules, as demonstrated by the section that follows.

5. **The Paradox of “Transfer Pricing” Rules: How They Backfire**

Counter-intuitively, transfer pricing rules have the following effect: inflation of accounting costs on a firm’s financial statements and failure to make transparent the economic profit made by the integrated producer. This unintended effect of transfer pricing rules stems from the incorporation of “opportunity costs” in the production of a good.²⁵ A firm produces a good by using inputs and incurring direct costs or operating expenses. In this context, the “opportunity cost” is the required rate of return “R” on direct expenses.²⁶ Integrated firms are likely to have the leverage to borrow funds at interest rates more favourable than those available to the non-integrated producer. Therefore, the competitive price for any good, say X, is less for the integrated producer.

²⁴ For convenience, the formula is restated: Un-integrated profit = 1000-2X where X = 200, resulting in MC = 600; P [price] = 1000 – x [200] = 800. Selling 200 units at 800 = $160 000 [revenue generated]. Given integrated MC = 100, real costs = 100*200 or $20 000, resulting in profits of $140 000. With MC at 100, then X = 450 [1000 – 2*450] yielding total revenue of $247 000. Real costs are 100*450 = $45 000, yielding profits of $202 500.
²⁵ “Opportunity costs” is defined as the economic cost of an alternative that has been foregone. Cooter & Ulen, *supra* n. 21 at 34.
²⁶ The following analysis is based upon an unpublished paper by Dr. Dana Stevens. The paper is on file with the author. The text is a restatement of this insight.
than for the non-integrated producer precisely due to lower financing costs for the integrated producer thereby giving the integrated producer a competitive advantage. In other words, transfer pricing rules do not work to achieve their intended effect: to place the integrated producer and non-integrated producer on the same footing.

1. Illustration

Assume good S requires three inputs [A, B, and C] and requires direct expenses [operating costs] in its production. S is a function the three inputs \([S= f(A, B, C)]\). Each input is associated with operating costs. Expressed as a formula, direct expenses equal \(PaA + PbB + PcC\). The required rate of return, \(R\), on the direct expenses is the “opportunity cost” of producing good S. The opportunity cost is \(R[PaA + PbB +PcC]\). Total economic costs are \(TC = [PaA + PbB +PcC][1 + Rs]\) where \(Rs\) is the required rate of return on the production of S. Under competitive conditions, the producer does not make any “economic profit” profit since Total cost is equal to Total revenue. “Economic profit” is the difference between revenue received from the sale of an output and the opportunity costs of the inputs used. An economic profit accounts for a capital charge consisting of the WACC x Invested Capital. An accounting profit is not equivalent because it does not incorporate “opportunity costs”.

The required rate of return at each stage of the production process explains the effect of transfer pricing inflating accounting profits and hiding economic profits. Assume that the production of S requires an intermediate product T and the input C, the production of T requires the intermediate product Q and input B and the production of Q requires input A, then we have the following: \(S = f[T,C]\), \(T = f[Q, B]\) and \(Q = f[A]\).

If these intermediate products are produced independently by different firms and sold at competitive prices, then these prices are the “arm’s length” prices an integrated firm may be required to use for internal transfers. Computing the final independent price of S requires integration of the required rate of return on the production of each separate input.

Example:

- For nonintegrated: Competitive Price of S

\[Ps = [PaA(1 + Rq)(1 + Rt)(1 + R ) + PbB(1+Rt)(1+Rs) + PcC(1 + Rs)]/S 1000 – X\]

- For Integrated: Competitive Price of S

\[Ps = [PaA + PbB +PbC](1+Rs)/S\]

The integrated producer earns a mark-up at the earlier stages of production. Assume \(Rs = 20\%\) (.2). If we allocate 60% of the Required Rate of Return at stage 1, and 20% at stage 2 of the production process, then profits = \(PaA(0,6) + PbB(0,24)\). The problem is compounded when the required rates of return differ at each stage of the production process.

27 To demonstrate the difference between economic profit and accounting costs, consider the following example. An entrepreneur invests $300 000 in a business. After year 1, the business returns profits of $350 000 in profits. The accounting profit is $50 000. However, assume the entrepreneur could have earned an income, if employed, of $200 000, then the entrepreneur has incurred an economic loss of $150 000. In our hypothetical, the reverse effect is delineated, a bloated accounting cost and a hidden economic profit.

28 WACC = weighted average cost of capital.
Assume Rs = .2 (20%), Rq = .3 (30%), Rt = .25 (25%) and Rs = .05 (5%), then profits for the integrated firm are:

\[
PaA(1.3)(1.25)(1.05) [\text{or } PaA(1.7)] - PaA(1.05) + PbB(1.25)(1.05)[1.31] - PbB(1.05) = PaA(1.66) + PbB(1.26)
\]

It therefore follows that transfer pricing inflates the accounting cost of production at each stage of the production process thereby masking the economic profit earned by the integrated producer. The actual cost of financing required by the integrated producer is less than the accounting financial costs. The result is highly advantageous for the integrated firm.

6. **Rethinking Transfer Pricing Rules**

A significant corporate strategy is vertical integration or establishment of an M-Form company. Vertical integration refers to the purchase by a single firm of downstream entities such as suppliers of raw materials, and upstream entities such as assembly plants, service providers and distributors. Vertical integration creates a value chain. A vertically integrated firm need not add to its cost of production at each stage of the process a required rate of return or profit. Rather, a vertically integrated firm may defer profit maximisation until the final point of sale.

By contrast, a non-vertically integrated firm, at each stage of the production process, incurs not only the marginal cost of production from an unrelated firm, but also the required rate of return or profit demanded by that unrelated entity. Thus, the total cost of producing a good or service, and therefore the price charged to the ultimate purchaser is less for a globally integrated firm than for a non-vertically integrated firm. Viewed in this context compulsory transfer pricing rules undermine the benefit of vertical integration by forcing the M-Form global firm to behave as a collection of unrelated enterprises.

The conventional wisdom appears to be that, “Because … prices are not negotiated in a free, open market, it is possible to that they may deviate from prices agreed upon by non-related parties in comparable transactions under the same or similar circumstances”. However, the whole point of the M-Form Corporation is precisely to deviate from prices agreed upon by non-related parties, because the economic reality is that the divisional centres are related and constitute a single enterprise as an integrated company group.

Hence, transfer pricing destroys an economic benefit following from developments of how firms in a competitive market attempt to achieve price efficiency. In addition, transfer pricing rules confer an unintentional benefit upon integrated producers by allowing the producer to mask economic profit behind bloated accounting costs of production. Consequently, transfer pricing rules generate a loophole through which the integrated producer gains a competitive edge against the non-integrated producer.

7. **Alternative Solutions**

Criticism is easier than production of viable alternatives. The radical alternative is the elimination of transfer pricing regulation wholesale. If transfer pricing functions as a substitute

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for lost tax revenue from lower tariffs as a result of the multi-lateral trade system, then the radical alternative is justified as that is not the explicitly stated premise of transfer pricing regulation. The second alternative is to borrow the “economic reality” test to determine when “transfers” are made solely or primarily to evade taxes. The economic reality test focuses upon the genuineness of the transaction, not its form alone. These transactions can be voided and infringing companies punished stiffly. The social costs of imposing large fines are de minimus compared to the cost of global enforcement of transfer pricing rules. The third alternative is based again on the elimination of transfer pricing and allocating consolidated profits among members of a company group based on actual financing costs in the production of a good at each stage of the production process.

Conclusion

This article has demonstrated problems inherent in the assumptions of transfer pricing regulation. The approach to revenue collection is posited on a counter-factual economic reality, and disregards the benefits of vertical integration for profit maximization and lower prices for consumers. Equally insidious is the unintended advantage conferred on integrated producers. Given the difficulties of determining an arm’s length price and the cost of information sharing and tax adjustments among diverse Tax Administrations, it is essential to reconsider the underlying first principles of Transfer Pricing Rules with a view toward their revision, if not, elimination. The doctrinal rejection of the global formulary approach deserves to be revisited.

E.g., Donovan v. Agnew, 712 F.2d 1509 (1st Cir 1983)(applying the “economic reality test” in a labour case to determine the nature of an employment relationship); EEOC v. Dowd & Dowd, Ltd., 736 F.2d 1177 (7th Cir. 1984)(applying “economic reality test” to conclude that four doctors were “more analogous to partners in a partnership than to shareholders in a general corporation” and therefore were not employees for purposes of the federal anti-discrimination law [cited with approval in Clackamas Gastroenterology Associates v. Wells, 538 US 440, 441 (1984). The test also has been applied to mixed tax/labour cases, such as Hyland v. New Haven Radiology Associates, P.C., 794 F.2d 793, 798 (9th Cir. 1986)(refusing professional corporation to assert corporation status to reap tax and civil liability advantages and argue is a partnership to avoid unlawful employment discrimination liability)