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TRANSFER PRICING AS A PROBLEM OF MULTINATIONAL CORPORATION

Introduction

With growing specialization in production of components in different locations across the globe, intra-firm transactions account for a growing share of world trade. Accounting manipulations allow for a transfer of tax bases even if physical capital (real activity) remains intact, as multinational enterprises (MNEs) attempt to exploit differences in marginal statutory tax rates across countries, either actual or de facto (if there exist differing laxities with which tax administration is carried out). In most situations, this involves maintaining a judicious setting of the imputed values on the internal transfer of goods and services between operations in different countries. Such tax-shifting manipulations in which intra-firm sales are invoiced (i.e. “transfer pricing”) is often arbitrary, since no formal sales occur, and firms can play strategic games in an effort to lower their tax liabilities. The customary notion of “arm's length transaction” is not always easy to apply in practice. As the globalization process unfolds further, it may be increasingly difficult to sustain the current methods of taxing MNEs operating in different tax jurisdictions. Instead of taking each jurisdiction as a separate entity as is currently done, consideration may need to be given to the adoption of the unitary or worldwide tax base for the corporate income tax, with an internationally agreed system of tax credits or allocation procedures to prevent double taxation and to maintain international competitiveness.

1. Taxation Trends in the Global Economy – the aspect of tax competition

Globalization is bringing revolutionary changes. The essence of the internationalization process is aptly described by U. Beck, who thinks that globalization means that national boundaries are becoming less relevant to in the areas of social life, subject to this process. Distances are removed and people take the transnational lifestyle. Under such conditions, nation-states less control of the processes occurring on their territory and part of social and economic life is transferred to the post-sovereign space (Rosenau, 1996, p. 251).

The process of globalization is exposing a deep line between group who have the skills and mobility to flourish in global markets and those who either don't have these advantages or perceive the expansion of unregulated markets as inimical to social stability and deeply held norms. The result is several tension between the market and social groups such as workers, pensioners, with governments stuck in the middle. Another consequence of globalization is increased tax competition.

According to Stewart and Webb tax competition is a phenomenon that reflects the interaction of policy instruments and behavioral responses by taxpayers. In terms of policy instruments, tax competition typically is expected to take the form of government decisions to lower tax rates or make tax incentives more generous, thereby presumably improving the attractiveness of investments within their jurisdictions. However, even if tax policy does not change, behavioral responses by taxpayers to either a lowering of barriers to cross-border investments or a lowering of tax rates in other countries could cause tax revenues to fall in countries that had not introduced any changes in policy. This could occur as a result of either income-shifting – when corporations shift profits to affiliates located in low-tax jurisdictions by manipulating transfer prices or inter-affiliate loans and interest payments – or the shift of direct investments to the lower-tax jurisdictions (Stewart, Webb, 2006, p. 156-157).

In a globalized environment there are many governments have responded to globalization* with tax cuts designed to improve competitiveness and spur growth. Individual income tax rates have plunged in recent decades, and more than two dozen nations have replaced their complex income taxes with simple flat tax. At the same time, nearly every country has slashed its corporate tax rate, recognizing that business investment and profits have become highly mobile in today's economy. For the private sector this fiscal aspect could be considered as a positive consequence of globalization. But the bad news is that some governments (e.g. Germany or France) and international organizations are trying to restrict tax competition. A battle is unfolding between those policymakers wanting to maximize taxation and those understanding that competition is leading to beneficial tax reforms.

Since 1980, assuming the dynamics of technological development has significantly changed the economic landscape, which potentially had a particular

* Many countries increasingly compete to become the legal or financial homes for corporations. Low-tax countries, such as Bermuda and Ireland, have become compelling legal homes for firms from many countries. National stock exchanges actively compete for listings of foreign firms and many firms today are listed on a stock exchange outside their home country or on more than one stock exchange. And various countries, such as Dubai and Singapore, compete actively to be regional or global homes for managerial talent (Desai, 2008, p. 8).

impact on “architecture” of tax systems. V. Tanzi believes that it was dictated by the following factors (Tanzi, 1996, p. 6):

1. Openness of the economies in the internationalization of trade – growth in world trade was twice higher than the GDP growth which resulted in the fact that the current global economy has reached the highest level of integration which any observed.
2. Dynamic growth in trade was accompanied by equally dynamic growth in the free movement of capital, which was the consequence of reducing barriers to capital mobility resulting primarily from technological progress.
3. Increase the role of multinational enterprises in the financing of direct investment and the allocation of its activities in various parts of the world which has created new problems for tax authorities to escape in the form of profits to tax haven.
4. Trend is growing for the free movement of labor, while reducing the transport costs and efforts to obtain more and higher incomes meant that the sources of income of individuals were very often located in other countries than the place of residence of those persons, therefore, in the absence of adequate regulations were placed in tax revenues to budgets of other countries. The problem also has a second face namely the fiscal drain on government revenue which resulted also from the fact that part of the earned outside the country of residence, income was spent in another country, and so was the loss of taxes on both the direct and indirect.

These implications of forced adaptation to the new tax systems, economic and social realities to be fixed by taking the momentum of globalization. It should be emphasized that globalization is not primarily limited to financial matters, although the financial aspects are assigned a special space. The essence of a new quality of social life associated with globalization processes is determined differently. First, it points to a comprehensive process of global interpenetration, national and individual aspects of social life (Piertaś, 2002, p. 7). Secondly, this phenomenon is associated with an increase in various types of connections, interconnectedness, impacts in all areas of life. Thirdly, is introduced to distinguish the phenomenon of globalization, which manifests itself in the network of interdependence for multi-continental scale and the processes of globalization, which is a dynamic process of growth the level of globalism (Nye, Donahue, 2000, p. 2).

Just since the mid-1990, the average corporate tax rate in the 30-nation Organization for Economic Cooperation and Development has fallen from 38 percent to 27 percent*. During the same period, the average rate in the European

* It should be emphasized that statutory corporate income tax rates have been widely used as a simple, highly visible measure of the intent of policy makers. If governments were under serious international competitive pressure to reduce the tax burden facing internationally mobile investors, one might expect to see statutory tax rates decline through a process of competitive tax cutting. In fact, statutory corporate tax rates have fallen substantially over the past 20 years, and this is often cited in popular critiques of globalization (Stewart ,Webb, 2006, p. 158).

Union plunged from 38 percent to 24 percent (KPMG International). But corporate tax cuts have spread beyond the OECD countries. This decade, there have been cuts in far-flung places such as Albania (20 to 10 percent), Egypt (40 to 20 percent), Mauritius (25 to 15 percent), and Russia (35 to 24 percent).

Since 2000, corporate tax rate have included Austria (34 to 25 percent), Canada (45 to 34 percent), Germany (52 to 30 percent), Greece (40 to 25 percent), Iceland (30 to 18 percent), Italy (41 to 31 percent), The Netherlands (35 to 26 percent), and Portugal (35 to 25 percent).

Most countries have also cut tax rates on dividends and capital gains. Many countries have cut or eliminated taxes on estates and inheritances, and many have abolished annual taxes on wealth, which used to be popular in Europe. Further, withholding taxes on cross-border investments have been cut sharply around the world. Finally individual income tax rate have also been cut sharply. The average top rate in the OECD has plummeted 26 percentage points since 1980 (Edwards, Mitchell, 2008, p. 3). The trend is global, with the average top rate falling by a similarly large in Africa, Asia, Europe, Latin America, and North America. In addition, 25 nations have scrapped their multi-rate income taxes and installed flat taxes. The average individual tax rate in this “flat tax club” is just 17 percent (Table 1).

Flat tax countries have made the choice to scrap multi-rate, or “progressive”, income tax systems in favor of single-rate systems that have fewer deductions, exemptions, and credits. As is contrary to the interests of most politicians because it prevents them from micromanaging the economy through the tax code. Under a flat tax, politicians would not be in the business of offering narrow tax benefits to certain interests. Another hurdle to reform has been that some experts and international organizations have argued that flat taxes are not practical in the real world. Some critics continued to dismiss the spread of the taxes as if it were a temporary fad. An International Monetary Fund (IMF) study in 2006 stated boldly, “Looking forward, the question is not so much whether more countries will adopt a flat tax as whether that have will move away from it” (Keen, Kim, Varsono, 2006). Yet a more nations have joined the flat tax club since the IMF assessment, including the first mature and high-income economy, Iceland.

Table 1

The Flat Tax Rate: Income Tax Rate, 2008

| Jurisdiction | Year Individual Flat Tax Adopted | Individual Flat Tax Rate | Corporate Tax Rate |
|--------------|----------------------------------|--------------------------|--------------------|
| Jersey | 1940 | 20.0% | 20.0% |
| Hong Kong | 1947 | 15.0% | 16.5% |
| Guernsey | 1960 | 20.0% | 20.0% |

Table 1 cont.

| | | | |
|---------------|------|-------|-------|
| Jamaica | 1986 | 25.0% | 33.3% |
| Estonia | 1994 | 21.0% | 21.0% |
| Lithuania | 1994 | 24.0% | 15.0% |
| Latvia | 1995 | 25.0% | 15.0% |
| Russia | 2001 | 13.0% | 24.0% |
| Slovakia | 2004 | 19.0% | 19.0% |
| Ukraine | 2004 | 15.0% | 25.0% |
| Iraq | 2004 | 15.0% | 15.0% |
| Romania | 2005 | 16.0% | 16.0% |
| Georgia | 2005 | 12.0% | 15.0% |
| Kyrgyzstan | 2006 | 10.0% | 10.0% |
| Pridnestrovie | 2006 | 10.0% | 10.0% |
| Trinidad | 2006 | 25.0% | 25.0% |
| Iceland | 2007 | 35.7% | 18.0% |
| Kazakhstan | 2007 | 10.0% | 30.0% |
| Mongolia | 2007 | 10.0% | 25.0% |
| Macedonia | 2007 | 10.0% | 10.0% |
| Montenegro | 2007 | 15.0% | 9.0% |
| Albania | 2007 | 10.0% | 10.0% |

Source: Edwards, Mitchell (2008, p. 61).

Governments started the ball rolling for tax competition when they began to remove controls on capital movements in the 1970s. The deregulation of capital gave investors more freedom to diversify their portfolios and they ultimately purchased trillions of dollars of foreign securities. Meanwhile, corporations expanded their networks of affiliates worldwide*. The result is that investors and corporations now look globally to maximize their returns and minimize their taxes.

While tax reforms have generally reduced corporate tax rates globally, continued international tax differentials are an enduring feature of the global fiscal

* There are many examples of firms with homes outside their country of origin. Forty percent of Chinese red chip companies listed in Hong Kong are legally domiciled in the Caribbean. New firms, too, no longer routinely establish themselves in their founders' country of birth. When Accenture, the global consulting division of Arthur Andersen, became an independent firm in 2000, it incorporated in Bermuda and listed its shares in New York. The founder of the start-up business Pixamo, a photo sharing website based in Cambridge, Massachusetts, considered Delaware, Switzerland and the Ukraine as corporate domiciles prior to the firm's first round financing (...). Many firms with global activities have created regional headquarters. The natural next step has been to relocate traditional headquarters activities to the regional headquarters best suited for the purpose. For example, an American multinational firm headquartered in Chicago might find itself with a European regional headquarters in Brussels and an Asian regional headquarters in Singapore. Shortly thereafter, the global treasury and financing function might usefully migrate to Brussels and the global information technology function might usefully migrate to Singapore (Desai, 2008, p. 4).

environment. In this context, multinational firms can reduce their worldwide tax payments by shifting income from highly taxed jurisdictions to more lightly taxed locations. While income shifting can be accomplished through the reallocation of real activities, it can also be attained by shifting reported income, as occurs when firms manipulate their transfer prices on international transactions (Swenson, 2000, p. 7).

Globalization has become a strategic practice especially for multinational enterprise (MNE), both in terms of manufactured goods that have been produced offshore for more than two decades and the recent growth in offshore business services and intangibles.

At the level of the source it has to be accepted that any firm currently operating in a geographical and political territory will use supplies both from inside and outside that territory and will offer services to customers inside and outside that territory. This is not only an economic fact but also a legal option under WTO rules and – even more effectively but with different intensity – under regional frameworks such as the European Union, NAFTA, and similar areas of free trade. Free movement of financial capital in “real time” hardly meets any legal or technological limits around the globe. E-commerce renders longstanding assumptions about economic presence more or less meaningless. Moreover, the activities of a single firm might quite often stretch across geographical and political boundaries, thus making it more and more difficult to recognize and evaluate the respective contributions of different (legal or factual) units of the firm to the final outcome. This is most prominently reflected in the eternal debate on the reliability of transfer pricing methods, where the traditional instruments (comparable uncontrolled prices, cost-plus or profit minus methods) are more and more supplemented by “modern” but increasingly arbitrary tools (transactional net margin method and profit split method) (Schön, 2009, p. 68).

Large enterprises account for a major share of international investment, and there is a trend toward large-scale international mergers. At the same time, foreign investment by small- and medium-sized enterprises has also increased and these enterprises now play a significant role on the international scene. Multinational enterprises, like their domestic counterparts, have evolved to encompass a broader range of business arrangements and organizational forms. Strategic alliances and closer relations with suppliers and contractors tend to blur the boundaries of the enterprise (OECD, 2008, p. 9).

In the globalized economy, raising tax revenues on multinational firms has become increasingly difficult for governments, for at least two reasons. First, competition to attract mobile firms creates a downward pressure on profit taxation. Second, multinational firms may take advantage of tax differentials by manipulating profits across jurisdictions (Peralta, Wauthy, Tanguy van Ypersele, 2005, p. 24-25).

2. Transfer pricing – the key point for international taxation

Multinational firms have several tools to shift profits out of high into low tax regions. These include the option to finance an affiliate with debt or equity, the organizational form (e.g., to own the affiliate or to engage in a joint-venture with a local firm), or the payment of management fees or royalties between the parent company and its affiliates.

Designing transfer pricing systems is a central instrument for management control because transfer prices can be set to accomplish certain objectives (Figure 1). These objectives are likely to be conflicting, which makes it hard for the companies to construct an optimal model for transfer pricing. Some objectives will encourage the managers to charge a higher price, while others will promote a lower price. This forces managers to make trade-offs since no single transfer pricing method serves all purposes (Hjertberg, Pettersson, 2010, p. 17).

As a result, more than one-third of world trade in goods, services and intangible assets occurs between firms that are related to one another, for example, between two subsidiaries of a multinational firms. Trade between related firms is called intrafirm trade. The price of an intrafirm transaction, called a transfer price, affects the allocation of profits between the buyer and seller firms; a high transfer price shifts profits to the seller, a low price to the buyer.

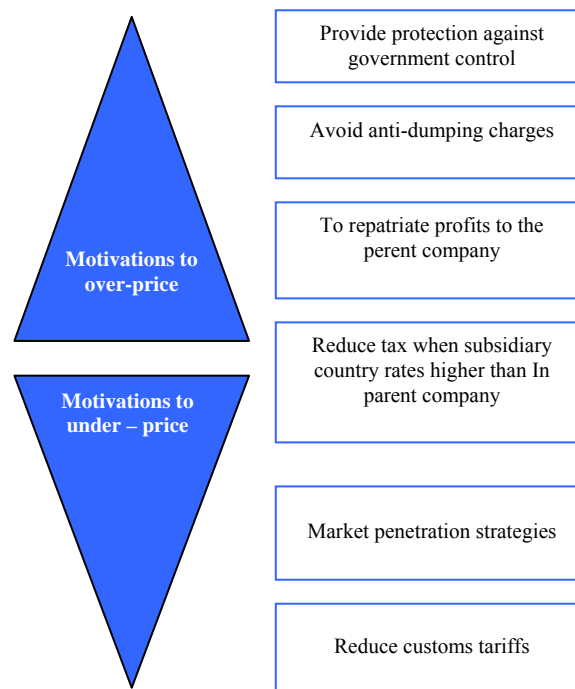


Fig. 1. Strategic Transfer Pricing

Source: Anthony, Govindarajan (2007, p. 8) in: Hjertberg, Pettersson (2010, p. 18).

Domestic transfer pricing is mainly about economic allocations of resources, it is about finding the optimum trade-off between costs and revenues and the performance evaluation between divisions is very important. Hence the aim is to increase the overall profit for the firm as a whole (Hjertberg, Pettersson, 2010, p. 21).

When intrafirm trade crosses national borders, it is called international transfer pricing, or simply transfer pricing. The manipulation of transfer is another widely used instrument. International transfer prices make the already complex situation even more complex since more dimensions are added to the price-making decision. One complex and highly discussed issue is when an internal cross-border transaction occurs, activities are undertaken in different tax jurisdictions which can have large effects on the pricing (Hjertberg, Pettersson, 2010, p. 21).

The economic rules suggest that the highest transfer price would be market price and the lowest transfer price would be differential cost. Depending on the options available to the buyer and seller, some other transfer price might be chosen between these two extremes. Economic rules work best in a domestic business environment where both buyer and seller divisions are taxed at the same corporate rate, because the tax rates do not affect the outcome.

While the economic principles work well for domestic transfer prices, they differ substantially from international rules. Each country legislates and enforces its own transfer pricing laws. A multinational enterprises with foreign divisions must then comply with tax laws for each country in which one of its divisions is domiciled. Every transaction between company sub-units is subject to audit by two sets of tax authorities. Tax compliance places a heavy burden on MNEs and takes precedence over economic rules (Drtina, Reimers, 2009).

Transfer pricing refers to the terms and conditions surrounding transactions within a multi-national company. It concerns the prices charged between associated enterprises established in different countries for their inter-company transactions, i.e. transfer of goods and services. Since the prices are set by non independent associates within the multi-national, it may be the prices do not reflect an independent market price. This is a major concern for tax authorities who worry that multi-national entities may set transfer prices on cross-border transactions to reduce taxable profits in their jurisdiction. This has led to the rise of transfer pricing regulations and enforcement, making transfer pricing a major tax compliance issue.

But a MNE has to manage its overseas transactions in a world characterized by different international tax rates, foreign exchange rates, governmental regulations, currency manipulation, and other economical and social problems. One of the most important things is to reduce the global income tax liability for the

MNE and problem focus on double taxation. According to analyses made by Hjertberg and Petterson situation is as follows (Hjertberg, Petterson, 2010, p. 23-26).

An economic double taxation situation arises when the same income are taxed twice. For MNEs this occurs when there is a conflict of interest between the tax authorities in the countries involved in the transaction. The tax authority in each country wants to protect their tax base and gain as large income as possible. They can have laws and regulations that differ and raise claims at the same income. For example there can be differences in definitions on the requirements for unlimited tax obligations or in the definition of associated enterprises, what is considered to be the permanent place for the operation or different rules of what is considered to be incorrect pricing or transfer loss (Nguyen, 2009).

Assume that there is a difference in definition of associated enterprises. Country A requires at least 50% holding to consider companies associated while country B requires 30%. In country A, the income tax is 25% while in country B 35%. Then assume that company B in country B buys goods from company A in country A in which they hold 31% of the shares. The cost of goods sold is 50 and the price is set to 100 (Figure 2).

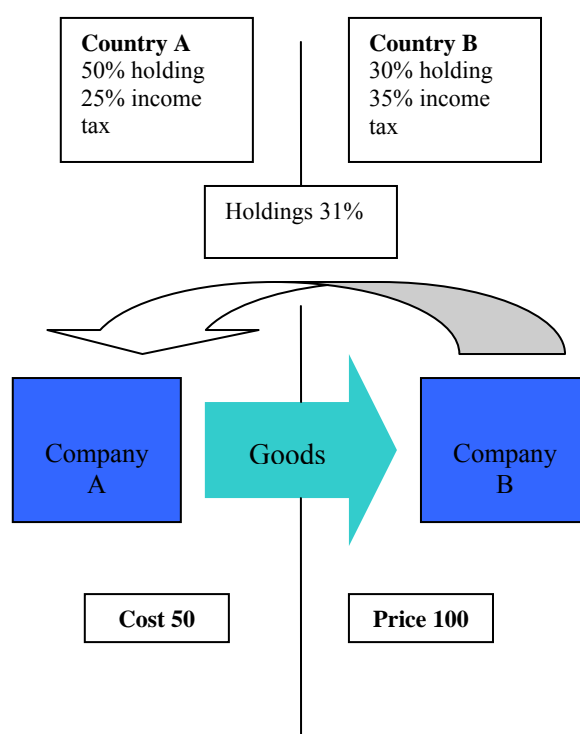


Fig. 2. Cross-border Transactions

Source: Hjertberg, Petterson (2010, p. 24).

In country A no transfer pricing adjustments is required since the transaction does not meet the requirements for the definition of associated companies. They produce it for 50 and sell it for 100. If we then assume that Company B buys the goods for 100 and then resells it for 80, i.e. they make a loss at the transaction and income are shifted from Country B to Country A which has a lower income tax. If both countries didn't consider this as a transaction between associated companies the income tax would have been 12.5 payable for company A (50×0.25) and 7 receivable for company B (-20×0.35). This means a global income tax at 5.5 for the group since they transfer goods to a high price from a country with lower income tax to a country with higher.

But since the transaction lives up to the requirements for associated companies in country B, the tax authority will probably assert incorrect pricing and instead adjust the price at the purchased goods from 100 to let us say 60, i.e. Company B (in a tax point of view) suddenly make a profit at 20 on the transaction instead of a loss at 20, which would lead to a payable income tax at 7 (20×0.35). So the total global tax would be 19.5 since a part of the profit is rated in two countries. This incorrect pricing will not be advantageous for the associated companies due to the transfer pricing regulations since it leads to double taxation.

Scenario 1: No associated interest between the companies

A: 12.5 payable income taxation B: -7 receivable

Total global taxation 5.5

Scenario 2: Associated interests between the companies with incorrect pricing

A: 12.5 payable income taxation B: 7 payable

Total global taxation 19.5

Scenario 3: Associated interests between the companies with correct pricing

A: 2.5 payable Income taxation B: 7 payable

Total global taxation 9.5

If the group sets a correct price, according to the arm's length principle, they can avoid these extra costs. Assume that an added margin at 20% of cost of goods sold is a result of the arm's length principle between the companies. Then Company A would sell for 60 to Company B and pay 2.5 in tax (10×0.25), while company B buys for 60 and sells for 80 which means a payable income tax at 7, this gives us a global income tax at 9.5. Not as good as 5.5 but way better than 19.5. This is just one example over when a double taxation can occur. Another easier example at double taxation is when a profit in a subsidiary in country A is taxed and then transferred to the parent company in country B where it is taxed again.

Double taxation is a barrier that discourages investors from conducting business and investments in foreign countries. It is not beneficial for anyone and therefore tax authorities have developed double tax relief measures to reduce or eliminate international double taxation. (Nguyen, 2009). It seems important to mention the statement (as a kind of summary) “The golden rule is that tax treaties can never extent a country’s taxing right, only reduce it” (Hjertberg, Pettersson, 2010, p. 26).

3. OECD Recommendation for the transfer pricing

According to international standards individual group members of a multinational enterprise must be taxed on the basis that they act at arm’s length in their dealings with each other. This arm’s length principle is found in article 9* of the OECD Model Tax Convention** and maintained and developed in the 1995 OECD Transfer Pricing Guidelines (OECD, 2010):

“[When] conditions are made or imposed between (...) 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”.

OECD member countries continue to endorse “*the arm’s length*” principle as embodied in the OECD Model Tax Convention (and in the bilateral conventions that legally bind treaty partners in this respect) and in the 1979 Report. These Guidelines focus on the application of the arm’s length principle to evaluate the transfer pricing of associated enterprises. The Guidelines are intended to help tax administrations (of both OECD member countries and non-member countries) and MNEs by indicating ways to find mutually satisfactory solutions to transfer pricing cases, thereby minimizing conflict among tax administrations and between tax administrations and MNEs and avoiding costly litigation. The Guidelines analyses the methods for evaluating whether the conditions of commercial and financial relations within an MNE satisfy the arm’s length principle and discuss the practical application of those methods. They also include a discussion of global formulary apportionment (OECD, 2010, p. 20).

In the OECD Report there are several reasons why OECD member countries and other countries have adopted “the arm’s length” principle, (see OECD, 2010, p. 34-35).

* For permanent establishments the principle is established in Article 7 of the OECD Model Tax Convention.

** OECD Model Tax Convention on Income and Capital, first published in 1963 and periodically updated since then.

The universally accepted approach for setting a transfer price is referred to as the “arms-length standard”. Deloitte Tax LLP (2007), an international consulting firm, defines this as “the price at which two unrelated parties agree to execute a transaction”. Despite the fact that countries worldwide use the arms-length standard to set transfer prices, they enact rules that can lead to different interpretations of what the price should be. Companies are stuck with compliance burdens on each side of the transaction. Meeting the rules of one country does not guarantee that the other’s requirements will be met (Drtna, Reimers, 2009).

It seems that in principle, ‘transfer pricing’ based on “the arm’s length principle” represents a coherent and sound concept for establishing the correct attribution of company profits between countries. But not quite, the setting of intra-group transfer prices in accordance with the separate entity approach and the arm’s length principle does not necessarily correspond to the prices set for business reasons (effectiveness, performance measurement etc.). This has always been the case. However, business representatives maintain that the very concept of “the arm’s length principle” will in the future lose its underlying commercial rationale. This is because large companies, in view of their EU-wide corporate restructuring, adopt so called Euro-pricing (European Commission, 2001, p. 292).

An alternative to the “arm’s length principle” can be “global formulary apportionment”. Global formulary apportionment would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula. There would be three essential components to applying global formulary apportionment: determining the unit to be taxed, i.e. which of the subsidiaries and branches of an MNEs group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit.

The formula would most likely be based on some combination of costs, assets, payroll, and sales. But OECD member countries do not accept these propositions and do not consider global formulary apportionment a realistic alternative to the arm's length principle, for the reasons discussed below.

4. European Union Recommendation for the transfer pricing

The European Union role in taxes is mainly limited to indirect taxation and tax state-aid. Articles 90 to 93 EC specifically deals with tax provisions. However, the scope of these articles is limited as they only allow the European Commission to work on “(...) provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and

the functioning of the internal market within the time-limit laid down in article 14". Article 87 EC on State aid provides another rationale for intervening when a tax distorts competition by favoring certain undertakings or the production of certain goods and affects trade between Member States. Despite its strict formulation, this article has been widely used by the European Commission to remove harmful tax measures.

However in The Company Tax Study, the Commission identified the increasing importance of transfer pricing tax problems as an Internal Market issue: although all Member States apply and recognize the merits of the OECD "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", the different interpretations given to these Guidelines often give rise to cross border disputes which are detrimental to the smooth functioning of the Internal Market and which create additional costs both for business and national tax administrations (European Commission, 2001, p. 9).

Member States' legislation generally also obliges domestic intra-group transactions to take place at arm's length. However, in practice, transfer pricing is mainly a cross border issue which creates specific compliance costs and contains a risk of double taxation. Multinational enterprises with cross-border transactions find themselves confronted with a number of difficulties that are explored in detail below (European Commission, 2001, p. 259-260):

- documentation requirements (sometimes heavy),
- the risk of penalties and economic double taxation,
- the costs of temporarily having to finance the same tax burden
- twice,
- increased auditing by the tax authorities.

A general problem in this context for multinational enterprises is the one of uncertainty. It is claimed by business that there is a risk of suddenly having a business structure which has perhaps been in place for a number of years undermined by the tax authorities who will – for transfer pricing reasons – no longer accept it from a tax point of view. Moreover, according to the business representatives in the panel it is not uncommon that a certain structure and/or transfer price (or the application of a specific method) might be acceptable to one Member State but not to another.

Transfer pricing thus represents an additional burden for a company in one Member State to set-up and/or conduct business with an affiliated company in another Member State, and instead favors domestic investments/transactions. Furthermore, as independent enterprises are not subject to transfer pricing regulations on cross border transactions they will be in a better position than multinational enterprises. Transfer pricing can also affect the location of cross border investments. All other things being equal, a company would be less likely to set-

up a subsidiary or branch in another Member State with a stricter transfer pricing policy than in another Member State with more lenient rules.

The report (European Commission, 2001) stresses the increasing differences between the transfer prices calculated for tax purpose and the underlying commercial rationale. It also pointed to the high compliance costs imposed by the Member States in the form of documentation requirements, the differences and uncertainty of the treatment of those operations by national tax authorities, the lack of use of the arbitration convention (90/436/EEC) and the subsequent double taxation.

The report estimates that “(...) medium sized multinational enterprises spend approximately EUR 1 to EUR 2 million a year on complying with transfer pricing rules” and that “(...) large multinational enterprises incur compliance costs related to transfer pricing of approximately EUR 4 up to EUR 5.5 million a year. These figures do not include the costs and risks of double taxation due to transfer pricing disputes” (European Commission, 2001, p. 343). To overcome these difficulties, the European Commission has proposed to establish a Code of Conduct to standardize the documentation that companies must provide to tax authorities on their pricing of cross-border intra-group transactions (European Commission, 2004).

Schön assumes that corporate law influences business decisions on transfer pricing in two respects: On the one hand, corporate law rules on the protection of minority shareholders and creditors provide a framework for intra-group transactions which the management is not allowed to transgress. Within this framework, the management is bound by law to pursue the goal of profit maximization, meaning on the one hand to increase to overall profit of the corporate group and on the other hand to reduce the overall tax burden of the corporate group. Insofar, the interaction of tax and business transfer pricing is governed by corporate law requirements. Managers will seek a balance between tax benefits and “tunneling” of profits to large shareholders (Schön, 2011, p. 4).

There is another aspect. Four of today’s biggest and fastest growing economies; Brazil, Russia, India and China, also known as the BRIC-countries, are for example non members of the OECD. Together they stand for one fifth of the world’s Gross Domestic Product (GDP) and almost half of the world population (Svenska Dagbladet, 2009). Even if the OECD standard has been really successful in contributing to a uniform global standard, there are a number of domestic considerations and peculiarities to be aware of. These considerations and peculiarities are of course more superior when dealing with non member countries. There are also other factors, besides laws and regulations, which can affect the transfer pricing strategies. The business environment differs among countries and there are cultural aspects and principles that can affect their transfer pricing strategies (Hjertberg, Pettersson, 2010, p. 12).

At this point raises the statement that there is no simple recipe for international tax coordination. There is no natural order of things in the international tax world. “Perhaps the most fundamental rule of international taxation” – as Bird and Wilkie have put it – “that there are no rules of international taxation” (Bird, Wilkie, p. 91).

5. Corporate tax coordination and the transfer pricing

Policy-makers often view transfer prices as being manipulated by multinationals to minimize taxes. Transfer pricing rules in many countries assume that the correct price to assess for non-marketed transactions is a comparable price of a similar arm’s length transaction adjusted for quality and other differential attributes such as business risk (see Bernard, Weiner, 1990; Eden, 1985).

As emphasized in the accounting literature transfer prices are essentially based on sales or costs of production (with an adjustment for an assumed profit rate), fails to recognize the role of transfer prices in influencing the behavior of subsidiaries that are controlled by the parent the transfer price may be used as part of an incentive scheme to induce divisions to improve their efficiency. If control is an issue, the transfer price need not be equal to the marginal cost of production since it influences the agency costs faced by the parent when controlling subsidiaries. Therefore, transfer pricing by multinationals may be used not only to minimize taxes but also to improve the efficiency of worldwide operations.

Business research focuses on the use of transfer prices to provide incentives for efficient resource allocation within a multidivisional firm; taxation rules strive to control transfer prices between head office, subsidiaries and permanent establishments within a multinational enterprise in order to allocate profits and ensuing tax revenue among the countries where the firm operates; corporate law uses a panoply of strategies to monitor related party transactions between corporate entities and their dominant shareholders as these might result in the diversion of the company’s assets to the detriment of minority shareholders or company creditors (Schön, 2011, p. 3).

It is widely accepted that companies seek to maximize profits. A multinational enterprises (MNEs) can help achieve this goal by shifting profits from high-tax to low-tax jurisdictions. For example, take Hungary, with a corporate tax rate of 16%, and France, with a tax rate of 35%. An MNC with divisions in these two locales will benefit by shifting more profit toward Hungary and less to France. Each division is controlled by corporate headquarters, which can set a transfer price to benefit the entity as a whole. The cases below illustrates how this works (Drtina, Reimers, 2009).

In Case 1, the Hungary division transfers goods to the France division and charges a sales price of \$1,000. (1) Hungary division’s revenue becomes France

division's cost of goods sold. Using the respective country tax rates, net income for the Hungary division is \$420 and for the France division is \$260.

Case 2 shows how these results differ if the Hungary division sells the same goods to the France division for \$600 instead of \$1,000. Now the France division's cost of goods sold is only \$600. As a result, the Hungary division's net income falls to \$84 and the France division's net income increases to \$520. Total company net income falls from \$680 to \$604—solely due to the change in transfer price and its impact on division taxes.

Case 3 shows the effects when tax authorities unilaterally impose a transfer price adjustment. Assume the Hungary division first used a \$600 transfer price, as in Case 2. Now Hungary's tax authorities disallow the \$600 price, claiming it does not represent arm's length. The Hungary division is forced to use a \$1,000 transfer price. Further, assume that the France division is unable to adjust the \$600 purchase price it first reported. Without adherence to any convention between the two countries, the result is double taxation because the government on the other end of the transaction does not provide a correlative adjustment. Total company net income falls from \$604 (Case 2) to \$540 (Case 3).

Blouin, Robinson and Seidman pointed to the hypothesis: whether corporate coordination of the firm's tax function or governmental coordination of tax enforcement affect the transfer pricing behavior of firms that face competing tax minimization incentives. According to them more centralized organizations have a higher likelihood of jointly considering both tariffs and income taxes when making transfer pricing decisions. Said another way, better coordinated firms are more likely to coordinate tariff and income tax minimization in their tax planning function (Blouin, Robinson, Seidman, 2011, p. 16).

Based on the survey Blouin, Robinson and Seidman find that when tariff minimization and income tax minimization cannot be achieved by using a single transfer price, the negative relation between income tax rates and reported pre-tax income is weaker. Specifically, a subsample of firms with significant conflicts between their tariff-minimizing and income tax-minimizing transfer pricing incentives (importing affiliates located in high tax countries and exporting affiliates located in low tax countries) exhibit a positive negative relation between income tax rates and reported pre-tax income. This suggests that transfer pricing decisions are made to minimize tariff payments rather than income taxes and is consistent with non-creditable taxes playing a more significant role in tax minimization strategies.

Ernst & Young (2008) reports that only 3 percent of tax directors of multinational firms view customs duties as the most important tax issue they face, while 39 percent stated transfer pricing for income tax purposes as the most important issue they face. Additionally, fewer than half (48 percent) of firms said

the person responsible for transfer pricing for income taxes has input over setting prices for customs purposes. Thus, there appears to be a wide range of overlap in oversight of tariffs and income taxes within an organization when setting transfer prices, and income tax minimization seems to play a primary role.

MNEs use different methods to achieve different results. Both internal and external goals can be determining the transfer prices. Common goals are performance evaluation of subsidiaries, motivating managers, tax reduction and strengthening of foreign subsidiaries. Transfer pricing can also be used to reduce foreign exchange risk, increase market shares, profit maximization and tax burden minimization.

A survey by Kim and Miller indicated that in the past, MNEs considered reducing income taxes as the most important corporate goal in designing their transfer pricing systems. Now, tax reduction is only a minor factor among many others, and the company's overall goal rather than income tax liability should be a major concern (Kim, Miller, 1979, p. 71). Another survey, by Jamie Elliott, found that an important factor that places constraints on a group's freedom to minimize direct taxes by fixing artificial transfer prices is the possible knock-on effect that this could have on indirect taxes (Elliott, 1998, p. 48-50).

The evidence of tax-motivated transfer pricing comes in several forms. Though it is possible that high tax rates are correlated with other location attributes that depress the profitability of foreign investment, competitive conditions typically imply that after-tax rates of return should be equal in the absence of tax-motivated income shifting fact that before-tax profitability is negatively correlated with local tax rates is strongly suggestive of active tax avoidance (Hines, 1999, p. 311).

According to Abdallah along with the reduction of global income tax liability, a major problem is how to coordinate the tax effect of transferred goods among different foreign countries to come up with the optimal transfer price. To set the appropriate transfer price for tax reduction, it is very important to determine the tax effects of different ways of taxing imports and exports by imposing duties and customs on them, and different tax rate structures and the methods of taxing MNEs' profits used by foreign countries.

It is not an easy task to determine the results of these effects on MNEs' global profits because there are frequent and rapid changes by host- and home-country governments to achieve some economic, political social objectives for their own countries

On the other hand the whole problem of maximizing profits at the lowest cost of tax is primarily focused around the transfer pricing to shift profits. However, in the literature, we find the view that there are other channels for shifting profits besides transfer pricing. One prominent channel is the extensive use of debt contracts between related parties in different countries (Bartelsman, Bettsman, 2000, p. 11).

Conclusions

International transfer pricing policies are generally set to maximize the after-tax profitability of worldwide business transactions. The minimization of income tax liabilities for an MNEs has been considered as the most significant factor or objective in designing transfer pricing policies in the foreign country, and consequently, if a transfer prices shifts profits from a country with high tax rates to a country with low tax rates, the global profits will be maximized. However, tax authorities are concerned that MNEs could use these transfer prices to shift profits between related parties through cost of goods.

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CENY TYRANSFEROWE – PROBLEM FIRM MIĘDZYNARODOWYCH

Streszczenie

Globalizacja i internacjonalizacja wymiany handlowej oraz stosunków międzynarodowych nadały szczególnego wymiaru problemowi cen transferowych, co w szczególności objęło międzynarodowe korporacje. Na arenie międzynarodowej pojawiły się wytyczne umożliwiające wdrażanie rozwiązań w zakresie cen transferowych do narodowych systemów podatkowych, tworząc w ten sposób w miarę możliwości spójne otoczenie fiskalne dla tego typu transakcji, chroniąc tym samym dochody podatkowe przed ich odpływem do państw o bardziej liberalnych rozwiązaniach fiskalnych.