Current Trends and Corporate Cases in Transfer Pricing

Edited by Roger Y. W. Tang
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Reviewed by Professor Lorraine Eden,
TEXAS A&M UNIVERSITY

Within the small group of international business scholars who work in the transfer pricing area, Roger Tang is known for his several books, starting in 1979, that explore the transfer pricing practices of multinational enterprises (MNEs) through the lens of survey questionnaires. He has written extensively on transfer pricing regulations in multiple countries, focusing primarily on the United States, Canada, England and Japan, but it is the results of his corporate surveys that are best known and quoted. Along with the biennial Ernst & Young transfer pricing surveys (see, for example, Ernst & Young, 2001), they are important summaries of current managerial practices and concerns in this critical area of international taxation.

Tang's newest book, *Current Trends and Corporate Cases in Transfer Pricing*, continues this tradition. The book is split into two parts. The first part summarizes the results from 95 responses to a 1997-98 survey of selected firms from the Fortune 1000, which updates the surveys in his 1979 and 1992 books. The second - and more interesting and frustrating, to me – part consists of case studies of the transfer pricing practices in five U.S. multinationals (Whirlpool, Dow Chemical, Guidant, Masco and Eaton). The last chapter summarizes and makes comparisons across the five cases and links them to the survey results.

The book starts by describing four environmental changes that can affect MNE transfer pricing policies: the accelerating pace of globalization; increased government regulation of transfer pricing both in terms of depth and complexity of regulations and the number of countries imposing these regulations; changes in corporate organizational forms favoring strategic alliances and M&As; and information technology changes such as e-commerce. He argues these four environmental changes are interdependent and related, and will affect both the managerial and tax aspects of transfer pricing. The chapter concludes with a five-page summary of three conceptual frameworks (Eccles, 1985; Borkowski, 1990; Emmanuel and Mehafdi, 1994) that are combined to structure the survey and case studies.

The next chapter summarizes the results from Tang's new survey, which are similar to the findings in his earlier books and Ernst & Young (2001)). Almost 90% of the responding firms use transfer pricing; firms that do not, say their intra-company transfers were insignificant. The most frequent method for pricing domestic transfers was market

price; for international transfers it was cost plus. When looking at all possible methods, a different picture emerges, however. The breakdown of transfer pricing methods for domestic transfers was cost-based (53%), market-based (26%) and negotiated (17%), compared to a breakdown for international transfers of cost-based (43%), market-based (36%) and negotiated (14%). Thus, domestic transfers, overall, are more likely to use cost-based prices than are international transfers. In both cases, however, the probability that subsidiaries are left alone to negotiate transfer prices between themselves is small (14-17%) and does not seem to have changed much from the earlier surveys.

In terms of the environmental factors that influence transfer prices, the top three reasons in terms of mean scores and percentage of companies indicating an item was very or extremely important were U.S. transfer pricing and other tax regulations (75%), overall profit to the company (73%) and foreign transfer pricing and tax regulations (63%). The most important objectives of the MNE's transfer pricing systems were maximizing consolidated after-tax profits (42%), divisional performance evaluation (24%), and minimizing various government taxes (11%). Transfer pricing policy also tends to be highly centralized; 59% of companies say the parent sets policies after consulting with divisions (43%) or not at all (16%), compared to 22% of firms that say divisions set transfer prices. The remaining firms say that government regulations constrain their transfer prices.

The second part of the book deals with the five case studies. There are very few transfer pricing case studies available in the literature except transcripts of tax court cases, primarily because MNEs treat this information as strategic and are reluctant to share it. The best-known case studies are probably Eccles (1985) and Colbert and Spicer (1995) so these new cases are an important addition to the literature. They are laid out similarly in five sections on corporate mission, goals and strategies; business and geographic segment information; intra-company transactions and transfer pricing practices; income taxes and tax planning strategies; and some thoughts about future directions for the firm. The reviews are nicely written and typically include organizational charts and financial and segment data. Each case concludes with study questions that can be used, for example, to structure a classroom discussion in an MBA or managerial accounting course. I suspect that managerial and international accounting professors, in particular, will find these cases very useful teaching materials.

From the viewpoint of academic research, however, I would have liked to have seen, not less reporting, but more analysis that linked the cases to existing theories and research puzzles in the transfer pricing literature.

For example, Dow Chemical keeps two sets of books (p.72). First, for income tax purposes, international transfers are valued at market price less selling and other distribution expenses (a version of the resale price method). Second, for internal reporting purposes, the same transfers are priced at full production cost (in other words, the cost plus method).

These simple facts bring three theoretical issues to mind, none of which is discussed in the case. This means they must be drawn out by the reader or classroom instructor, or found in (yet to be written?) teaching notes. For both those starting out in the field and for transfer pricing experts, it would have considerably enriched the book if the theoretical issues and debates in the transfer pricing literature had been explained and linked to the cases.

First, transfer-pricing methods can yield strikingly different profit allocations between the buying and selling units, which are well understood by income tax authorities and the subsidiaries themselves. Transfer pricing theory tells us that the resale price method tends to shift the largest share of profits from an intra-firm transaction upstream to the manufacturer, whereas the cost plus method

tends to shift most profits downstream to the distributor. In other words, the resale price method under-rewards the distributor and over-rewards the manufacturer, while the cost plus method works in reverse! In the literature, this is called the *continuum price problem* (Eden, 1998). For tax purposes, Dow Chemical appears to be over-rewarding the manufacturer and therefore shifting taxable income into countries where the products are manufactured and out of countries where they are finally sold. The issue, then, is where are Dow Chemical's products being manufactured since that is where the profits, for tax purposes, are going.

The locations are not detailed in the chapter, but one hint comes from the information that Dow Chemical's external transfer pricing policy was set up in an Advance Pricing Agreement (APA) with the U.S. Internal Revenue Service. If manufacturing occurs primarily in the United States for sale elsewhere, then the resale price method allocates most profits back to the United States for taxing by the IRS. Why have not other governments rejected the resale price method and launched income tax reassessments designed to shift more of Dow Chemical's taxable income to their own jurisdictions, which is what theory would predict? The text says that the APA was unilateral, which means only Dow and the IRS negotiated the transfer pricing methodology; other governments were not involved in the negotiations (where presumably they might have contested the method). Tang also notes that the APA "strengthens the company's case when it negotiates with other national tax authorities" (p. 81), which supports the view that other governments might have different views about the best transfer pricing method.

Second, Eccles (1985) raised the issue of *two sets of books*, whereby the MNE keeps one set for internal decisions and a second for external decisions. He argued that there were costs to the firm of doing this, and often the costs overwhelmed the benefits. Dow Chemical is clearly working with two very different sets of books, yet the text says there has been very few internal transfer pricing disagreements, contrary to what Eccles predicted. More discussion here would have been helpful as to why multiple books work so smoothly for Dow.

Third, the Dow Chemical case has implications for the *centralization or decentralization of transfer pricing decision-making within the MNE*. In Dow, internal transfer prices (the ones using cost plus methodology) are set by the parent without consulting with the subsidiaries. Subsidiaries are not allowed to purchase materials or intermediate products from arm's length firms, unless upstream subsidiaries have a shortage. Corporate groups are internally evaluated on their financial performance using a economic value added (EVA) methodology. The MNE also uses an SAP system that keeps track of all internal and external transactions. These facts suggest that Dow Chemical has a highly centralized transfer pricing system in place, which would stifle disputes among the subsidiaries. There are costs and benefits to centralizing or decentralizing all strategic decisions, including transfer pricing, and again, it would have been useful to make the links to the theoretical literature (e.g., principal-agent problems, transaction costs, tensions between global integration and local responsiveness).

Dow Chemical is one of five cases in the book. Each is richly filled with details and well worth exploring. The last chapter in the book nicely compares and contrasts the five cases, together with a section linking the individual case study results to the questionnaire results. The most interesting parts of the last chapter are the transfer pricing and tax planning strategy comparisons. Whirlpool and Dow Chemical (for internal purposes only) use the cost plus method for transfer pricing (in effect, moving profits downstream). Guidant, Masco and Dow Chemical (for tax purposes only) use versions of the resale price method (in effect,

shifting profits upstream). Eaton, on the other hand, allocates profits based on a functional analysis of costs and benefits, backing into the transfer price. Other than the remark that businesses pick their transfer pricing methods based on "what is perceived to be optimal in their particular environment and situation" (p. 152), Tang sheds little light on these critical differences.

In terms of tax planning, Tang finds that all five MNEs use a variety of methods to reduce their overall tax rates, including setting up holding companies in tax havens, taking full advantage of tax incentives such as the (soon-to-be-defunct) U.S. Foreign Sales Corporation export incentive program, and shifting income to low-tax and expenses to high-tax locations. In light of recent corporate tax scandals (for example, Enron's setting up of hundreds of sham subsidiaries in tax havens), these practices would be a useful springboard for a class discussion of the ethical aspects of tax planning

Overall, Tang's latest book is quite good and should be read by scholars and practitioners alike. Transfer pricing is really about solving puzzles. Tang's book, particularly the five case studies, provides fascinating firm-level information that seldom appears in print form. For transfer pricing scholars, this is an important contribution -- even if it raises more questions than it answers.

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