Transfer Price Setting in Multinational Corporations

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Abstract

The globalization of the world economy in recent years has resulted in the rapid growth of multinational corporations (MNCs) and inter-company transfer of goods and services. The World Trade Organization (WTO) estimates that 50% of international trade are within multinational corporations. As a result, transfer pricing has become a more and more important issue for managers, tax authorities, and the accounting profession. This paper explores the role of transfer pricing in multinational corporations and the appropriate approach for transfer price setting. We found that different characteristics of MNCs call for varying management approaches for transfer price setting processes.

Key Words: Transfer Pricing, Multinational Corporation, Management Control, Decentralization

1. Introduction

Transfer pricing refers to the prices charged in intra company transfers of goods and services. The current era of globalization has resulted in the exponential growth of multinational corporations (MNCs). The number of parent companies increased three fold from 37,530 in 1995 to 78,817 in 2007. The number of foreign affiliates jumped almost four times from 206,961 to 794,894 in the same period. The volume of intra company trade within the MNCs is similarly formidable. (Folfas 2009) The World Trade Organization (WTO) estimates that 50% of international trade taking place within multinational enterprises. It is not surprising that transfer pricing becomes a more and more important issue for corporate managers, tax administrators, and the accounting profession. As the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines state, "Transfer prices are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different tax jurisdictions." Due to the worldwide financial crisis and increasing government deficits since 2008, tax authorities are expected to step up their effort in transfer pricing audits in an attempt to increase tax revenue. International tax professionals surveyed for industry publications usually cite transfer pricing as their number one area of interest.

Transfer pricing has long been examined by economic, management and accounting researchers. It is an extremely complex issue because a manager' transfer pricing decision often is subject to constrains while it aims to simultaneously achieve several objectives, some of which might be in conflict of one another. In the following sections, we will discuss the major constraints and objectives as identified by prior studies. Then we propose a new paradigm of MNC control and the appropriate transfer pricing strategies.

2. Legal Constraints

When MNCs determine their intra-corporation transfer prices, they have to take into account legal constraints of both the headquarters' and the foreign affiliate's domestic countries. Common constraints are repatriation restrictions, sociopolitical requirements, and, most importantly, tax rules, which is further explained in this section.

If left unchecked, MNCs have every incentive to use transfer price to move profit between tax jurisdictions with differential tax rates, thus minimizing total corporate tax. A parent company in a high tax country can purchase goods from its subsidiary in a low tax country at a price substantially above the market price. The subsidiary will report high profit, which will be taxed at the lower rate.

The parent company will report a low profit, or even appear to be in financial distress. Hence the MNC will benefit from the lower global tax expense. The tax authority of the subsidiary will not object to the transfer price, since their tax revenue is increased by an artificially high profit, but the tax administrators of the parent company will find the existing transfer price and lost tax revenue objectionable.

To avoid such disputes among tax jurisdictions, the OECD provides Transfer Pricing Guidelines based on the arm's length principle – that the transfer price should be the same as if the two affiliates were two independent companies. The arm's length principle is the framework for many bilateral treaties between OECD countries, and even non-OECD governments. The Guidelines provide considerable technical details as to how to apply the arm's length principle. The newest guidelines were published in 2010. However, the actual application is not easy. It is not always possible to find comparable market transactions to set an acceptable transfer price, especially for high tech innovations.

Despite the OECD's guideline for arm's length principle, it might still be possible for MNCs to manipulate their transfer prices. Samuelson (1982) demonstrated that the market prices of the intra-company traded goods, and the resultant transfer prices, can be affected by production and sales decisions by the MNCs. Eden (1983) used a partial equilibrium model to analyze the effect of the Canadian tariff regulations on MNC transfer prices. He found that the MNCs can change their production levels to counteract the effect of the tariff regulation. Halperin and Srinidhi (1987) extended Samuelson's model to examine the effect of alternative transfer pricing methods specified in the U.S. Section 482 tax rule, namely, non-market resale price and cost-plus price. Prusa (1990) reached similar conclusions by using information economics theory, where the MNC and the tax authority possess asymmetric information. In summary, researchers found that MNCs can often change their environmental, marketing, and production decisions to manipulate the arm's length transfer price. Alfons (2009) provided empirical evidence that MNCs did shift profit to their German affiliates when their host country tax rates were higher than that in Germany.

To protect their tax revenue, governments often give their tax administrators extensive power to challenge the reported transfer prices, adjust taxable income of MNCs, and impose stiff penalties. For instance, U.S. tax code section 482 granted such sweeping authority to the Internal Revenue Service. A 20% penalty is imposed on an MNC if the transfer price adjustment by the IRS exceeds $5 million. The penalty is increased to 40% of the additional tax where the adjustment exceeds $20 million. To reduce the risk of transfer pricing audit and any subsequent penalties, MNCs often enter into an Advance Pricing Agreement (APA) with the tax administrators. An APA is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a specific set of transactions over a fixed future period of time.

3. Conflicting Objectives

Transfer price can be an effective tool for MNCs to achieve many different objectives, such as profit maximization, cash flow management, marketing strategy implementation, production coordination, and employee motivation. For example, an MNC might need to keep the import price of its foreign subsidiary at a low level so as to enable it to enter a new market, obtain a target market share, or maintain a certain product mix. Among the various objectives, achieving maximum corporate-wide profit and divisional evaluation are often cited by managers as the most important goals of transfer pricing. Interestingly, these two objectives are often in conflict with each other.

Since transfer prices provide valuation for trade between divisions inside an MNC, they inevitably affect the divisional profit. Supposedly the transfer prices facilitate coordination between, and performance measure for, the divisions. However, decisions that maximize divisional profits often do not maximize global profit of the MNC. (Yunker 1983). Some researchers (Anctil and Dutta 1999, Smith 2002, Baldenius et al. 2004) recommended decoupling, that is, using different transfer prices for tax and performance evaluation purposes. However, MNCs are reluctant to use two sets of books lest that tax authorities might question the validity of the prices reported on their tax returns.

Some researchers used an empirical approach to find out managers' perceived relative importance of the various objectives and constraints in transfer pricing strategies. Burns (1980) received surveys from 62 of the Fortune 500 firms. She concluded that the five most important variables were: U. S. market conditions, level of competition in the foreign country, maintaining reasonable profit for the foreign subsidiary, U.S. taxes, and economic conditions in the foreign country. Yunker (1983) used 50 survey responses from the Fortune 500 firms.

She found significant relationship among the endogenous policy variables, namely, subsidiary autonomy, performance evaluation, and transfer pricing policy. She also found that these policies were related to company characteristics and environment factors. Tang (1992) used responses from 143 Fortune 500 companies. The most important variables were: overall global profit, tax differentials between countries, repatriation restrictions, competition environment in foreign country, and foreign customs duties and legislation. Al-Eryani et al. (1990) compared the transfer pricing factors of U.S. firms with affiliates in less developed countries with those of U.S. firms with affiliates in developed countries. They found that legal constraints, such as antitrust, antidumping, tax, customs, and financial reporting regulations, and firm size were key factors affecting transfer pricing strategies. These empirical surveys indicate that many factors are considered when managers set transfer prices.

In short, both analytical and empirical studies illustrate the complexity in the multinational transfer pricing environment. It has been found that managers strive to meet numerous, and often conflicting, objectives in their transfer pricing decisions, while at the same time subject to constraints imposed by the governments or market conditions. They have to decide on a transfer price that provides the optimal tradeoff among the objectives.

4. Transfer Price Setting

Due to the complexity of transfer pricing decisions, and the necessity to take into consideration local economic, social, political and legislative environment, some researchers suggest that the transfer pricing decision should be delegated to the divisional level. The divisional managers should negotiate a mutually acceptable price for goods and services traded between them. For instance, Svejnar and Smith (1984) used a game theory model to analyze the bargaining power between MNCs and local partners in less developed countries while they negotiated transfer prices. On the other hand, Halperin and Scrinidhi (1991) used a cooperative equilibrium model of decentralized MNCs to maximize global profit. They looked at the effects of negotiation power in decentralized corporations. The difference between the centralized and decentralized optimum represented the cost of decentralization.

While these economic models and empirical surveys have provided invaluable insights in the complexity of transfer pricing decisions, they fail to provide managers with practical guidelines regarding who should be making the transfer pricing decisions. Should the pricing strategies be formulated by the headquarters and imposed on the divisions? Or should the divisional managers given the autonomy to negotiate the transfer price with each other? In the following sections, we are going to draw upon management theories of MNC control and their implications on transfer pricing process. We divide the various theories into three categories: the structural control school, the intra-corporate school, and the transnational school.

5. MNC Control Theories and Transfer Pricing Strategies

5.1 The Structural Control School

The structural control school focuses on the inter-division relationship that the headquarters of a corporation should foster (Hill, Hitt & Hoskisson, 1992). These theorists recognize the need for a balance between functional specialization by the divisions and centralized oversight by the headquarters. Their primary conclusion is that *related* diversified organizations, which seek to exploit corporate economies of scope, would be better served by cooperative arrangements between divisions, while *unrelated* diversified firms, in their quest for internal governance advantages, would profit more from inter-division competition. Accordingly, our proposition is:

Proposition 1: MNCs enjoying economies of scale, whose divisional operations are more related to one another, are likely to perform better when divisions cooperate with one another. It is important for transfer prices in these MNCs to foster such coordination among the divisions.

5.2 The Intra-Corporate School

The intra-corporate school evaluates the level of openness, subjectivity and trust that can be incorporated into the corporate-division relationship. This branch of research focuses on a variety of control mechanisms deployed by the corporate headquarters, such as incentive systems (Govindarajan, 1988), inter-division resource sharing systems (Gupta & Govindarajan, 1986), corporate-division relations (Gupta, 1987), socialization of new entrants (Goold & Quinn, 1990) and the choice between behavior based and outcome based control mechanisms (Govindarajan & Fisher, 1990). According to this school, depending upon the environment that various organizations operate in, they can be classified either as *open* or *closed* systems. The table below depicts various characteristics, generic strategies and preferred organizational arrangements within open and closed systems:

OPEN SYSTEMS	**CLOSED SYSTEMS**
Miles and Snow strategy: Prospectors	Miles and Snow strategy: Defenders
Porter's generic strategy: Differentiation	Porter's generic strategy: Cost leadership
Open inter-division relationships	Competitive inter-division relations
Incentives linked to corporate performance	Incentives linked to division performance
Distributed information systems	Centralized information systems
Loose control systems	Tight control systems

The primary conclusion of this school is that open systems profit more from subjective, cooperative and trust-based inter-division relations, while closed systems are better served by objective, competitive and contractual inter-division relations.

Proposition 2: MNCs with an open system culture benefits from cooperative inter-division relations. It is more likely that transfer price decisions can be delegated to the divisional level in these MNCs.

5.3 The Transnational School

Scholars of the transnational school contend that the structure of an MNC is determined by its size and its level of diversity, such as its product range and geographic spread. Thus, it needs to experiment with a hybrid mixture of structures, including decentralization and centralization (Taggart, 1998).

There are four major disadvantages associated with excessive centralization in an MNC (Egelhoff, 1988):

- Overloading of top management team decision-making capacity.
- Time lost in moving information.
- Negative impact on motivation.
- The unavailability of specific information at the top level.

On the other hand, it has been argued that greater interdependence between divisions may require greater dependence on the top management team as a coordinator in inter-division transactions (Govindarajan, 1988). In such cases, the top management acts as a resource allocator or facilitator.

Proposition 3: MNCs characterized by high interdependence among divisions are likely to perform better when using centralized control systems than those using decentralized decision systems. Transfer prices set by a centralized control system is more desirable than by a decentralized system.

5.4 Agency Theory

Transfer pricing is an area of great potential conflict between subsidiaries, often leads to a need for mediation by corporate headquarters. If the transactions between subsidiaries are going to be conducted over a long term, formal negotiations between subsidiaries, with facilitation by the headquarters, would work best. However, in the case of ad hoc transactions between two subsidiaries, the relationship has to be negotiated with both sides by the corporate arbitrator, who possesses imperfect information. Both subsidiaries are then pulling toward a different equilibrium point, and the informational asymmetries in ad hoc transactions may often be so great that corporate interests would be best served by decentralizing the decision at the subsidiary level. It may be proposed therefore that the headquarters of an MNC should mediate the transfer pricing process only when large, multiple or long term orders are being negotiated. For ad hoc transfers, it would be best to relegate the decision to the SBU level, where they would follow a market-based course. Based on the above reasoning, we propose the following proposition:

P4: When negotiating inter-subsidiary transfer on a long term basis, corporate mediation is more likely to lead to better performance than market-based transactions, and vice versa.

6. Conclusion

In this paper, we discussed the complexity of transfer pricing of the MNC. It has to take into consideration of multiple objectives, some are in contradiction with one another, and try to come up with effective transfer price setting strategies. We addressed this issue first by examining the economic, as well as management, literature. We explored how the transfer price setting process should differ according to the characteristics of the MNCs. Such diversity in the control systems are already being implemented across MNCs. Many MNCs have begun to move from geocentric control systems towards a more transnational structure, which involves greater autonomy to the subsidiaries. In addition, some are also moving from a single tier control (headquarter-subsidiary) to a more regional system, where there is a two-tier system (headquarter-region-subsidiary).

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