International Transfer Pricing

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Abstract

International transfer pricing determines how the worldwide income of a multinational enterprise is divided among countries for income tax purposes when transactions occur within the firm. This review examines economics, accounting, legal research, and tax practitioner literatures on international transfer pricing.

The empirical literature documents the ability of multinational enterprises to shift income attributable to intangible assets and organizational capital from high-tax to low-tax countries. The theoretical literature reflects many different perspectives, but a recurring theme is that the current system that evolved in a world in which value was created by tangible assets with clear physical locations is not well suited for a world in which value is created by firms that develop intangible assets and choose organizational structures that economize on transaction costs.


DOI: 10.1561/1400000037.
This monograph reviews international transfer pricing. Taxable income for a multinational enterprise (MNE) is determined on the basis of separate accounting, in which the incomes of a United States (U.S.) parent and its foreign subsidiaries are determined separately. When goods or services are transferred between related entities the transfer price, i.e., the price at which the good or service is transferred, determines how the income of the two entities is divided between the U.S. and the foreign country for income tax purposes. If a U.S. manufacturing firm produce a widget at a cost of $20 and transfers it to its Dutch subsidiary, and the Dutch retailer in turn sells it to an unrelated party for $30, how the $10 profit is divided between the U.S. parent and the Dutch subsidiary depends on the transfer price. If the transfer price is $27, the U.S. parent has taxable income of $7 and the Dutch subsidiary has taxable income of $3. A particularly important type of service is the use of intellectual property that is developed in one country and used in another.

The rapid increase in globalization has increased both trade and foreign direct investment. Much of the increase has been in the form of intrafirm trade. [Eden 1998, p. 70] argues that intrafirm trade is
the *sine qua non* of the MNE. About 40% of U.S. international trade occurs between a U.S. firm and a related party in a foreign country \cite{Clausing2003}. The Organization for Economic Co-operation and Development (OECD) estimates that more than 60% of world trade takes place between related parties in MNEs \cite[2010, p. 5]{Wittendorf}. For some pairs of countries, 75% of cross-border trade occurs within MNEs \cite{Brem}. The increase in intrafirm trade means that transfer pricing has become much more important over time.

If the MNE could pick any price in an unconstrained fashion, it could shift all of its taxable income to the country with the lower income tax rate\footnote{Transfer prices are not the only way to shift income from a high-tax rate country to a low-tax rate country. For example, an MNE can reduce taxable income in a high-tax country by having high-tax rate affiliates do all of the borrowing or making all of the tax-favored R&D investments.} Therefore, tax authorities have coordinated on the arm’s length standard for determining whether the resulting allocation of taxable income is valid for tax purposes. The arm’s length standard involves a thought experiment, in which one asks what allocation would have arisen had the parties been unrelated, each striving to maximize its own income. This approach raises serious conceptual difficulties, as the economic theory of the firm indicates that two related entities within a vertically integrated firm will interact quite differently than will independent firms.

The research on international transfer pricing is found in journals that reflect very different research traditions. Leading papers can be found in economics journals, accounting journals, law reviews, and tax practitioner journals. This monograph puts more weight on the accounting and tax practitioner literatures, while striving to incorporate the most important contributions from the economics and legal research literatures. \cite{Eden} and \cite{Wittendorf} provide more comprehensive surveys of the economics and legal research literatures, respectively. Transfer pricing is just one part of how MNEs are taxed; \cite{Blouin} provides a review of the larger literature on the taxation of MNEs.

It is important to understand and appreciate the history of a field of study in order to put current disputes into perspective. Section 2
Introduction

briefly summarizes the development of the international tax regime from the post-World War I era through the most recent revision in the U.S. transfer pricing regulations, with particular emphasis on the areas of disagreement between the U.S. Treasury Regulations and the OECD Transfer Pricing Guidelines (hereafter, OECD Guidelines).

Section 3 summarizes the empirical evidence that shows that firms successfully shift income from high-tax to low-tax countries. Most of this evidence is based on firm-level data. Firms owning valuable intangible assets are particularly adept at shifting income attributable to intangible assets to low-tax jurisdictions. Other studies use product-level data rather than firm-level data. Both types of studies paint a compelling picture that shows that shifting income via transfer pricing is pervasive.

Section 4 examines some fundamental transfer pricing issues. I emphasize that the tax authorities define the arm’s length standard in terms of the profit one would expect unrelated parties to earn, not the price at which unrelated parties would transact. I also analyze the difference between economic profits and accounting profits. Models in the economics literature often treat the cost of equity capital as if it were deductible for tax purposes. This approach is analytically convenient but substantively mistaken.

Section 5 reviews the literature in which the transfer price is viewed as an optimal choice of the MNE. One set of papers focuses on the extent to which firms have discretion over the transfer price itself. In these studies, the firm can choose any price from a specified range. Not surprisingly, the firm chooses an endpoint of the range, as it strives to allocate as much income as possible to the country with the lower tax rate.

Another set of papers examines the dual roles played by transfer prices. One role is determining the allocation of taxable income within an MNE. The other role is a mechanism by which division within a vertically integrated firm with decentralized decision rights coordinate their actions. These papers model the tradeoff between using a transfer price for tax purposes and internal decision-making purposes. I argue, however, that the evidence supporting the existence of this alleged tradeoff in practice is quite weak.
A third set of papers examines the endogeneity of a comparable transaction with an unrelated party, in which the price from a transaction with an unrelated party is used to allocate income between related parties. The final set of papers examines the effect of the transfer price on investment incentives. In each case, the tax incentives distort investment choices, with ambiguous effects on economic efficiency.

Section 6 examines the issue of transfer pricing through the lens of transaction cost economics, in which firms vertically integrate in order to economize on transaction costs. The transactions costs associated with valuable intangible assets are particularly severe, so firms holding valuable intangibles tend to vertically integrate. This makes it difficult to identify comparable transactions between unrelated parties that can be used in order to implement the arm’s length standard. One particularly difficult issue arises when the organizational structure itself creates value. As the transfer pricing rules tend to focus on the location of tangible capital, the question of which political jurisdiction should tax the returns to organizational capital is difficult to resolve.

The papers that take a transaction cost economics perspective find that using an arm’s length price often does not yield an arm’s length allocation of taxable income, reflecting the fact that related parties interact in fundamentally different ways than do unrelated parties.

Section 7 addresses the issue of tax compliance. In practice, many firms are taxed by multiple political jurisdictions on the same income due to inconsistent transfer pricing rules. The prospect of double taxation has led to the use of institutional arrangements in which the MNE and one or more tax authorities agree upon transfer prices before the tax return is filed. These arrangements are known as advance pricing agreements, or bilateral advance pricing agreements in the case of agreements with two tax authorities. These agreements can make all three parties to be better off; even though taxes are zero-sum wealth transfers, the deadweight loss associated with audit costs can be reduced.

The difficulty that the U.S. government has taxing the income earned by U.S. MNEs, particularly those using valuable intangible assets, has led some to advocate changing to a system of formulary apportionment to replace the current system of separate accounting.
Section 8 describes formulary apportionment, with particular emphasis on the destination sales formulary apportionment system, and describes the advantages and disadvantages of formulary apportionment compared to separate accounting. In Section 9 I offer my thoughts regarding promising unexplored research questions. Section 10 concludes.
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