Transfer Pricing

Economics 689 Texas A&M University

Transfer Pricing

- UNCTAD (1999). Transfer Pricing
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  – Evidence that penalizing deviations from proper transfer pricing has lowered valuations of Japanese MNCs in the United States.

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• Tax law in OECD countries requires multinational enterprises (MNEs) set their transfer prices according to the arm's length standard = the external market or arm's length price that two unrelated firms would set for the same or similar product traded under the same or similar circumstances.
  • In 1990 the US government introduced a transfer pricing penalty for cases where MNEs deviated substantially from this standard – when they engage in transfer price manipulation (TPM).
    – More than two dozen other governments have followed suit.
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• Paper assesses the impact of the US transfer pricing penalty on the stock market valuation of Japanese MNEs with US subsidiaries in the 1990s.
  – The penalty caused a drop in their cumulative market value of $56.1 billion (an average $7 billion dollars per year), representing 12.6% of their 1997 market value.

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• This drop in market value can be compared with US Treasury estimates of $2.8 billion in annual forgone tax revenues due to TPM and $5.56 billion in recommended tax adjustments in 2002.
• Thus, the market value impact - on Japanese MNEs alone - appears to be larger than the US Treasury's estimates of forgone tax revenues.
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- MNEs are frequently audited. Audits often (a third of the time) lead to an adjustment = the MNE owes more tax to the national tax authority. The adjustments can include penalties now in many countries.
- MNEs spend a lot of effort figuring out how to set transfer prices to minimize overall tax bill, subject to risk of audit and penalty.
  - Most transfer prices, especially for services, have a little “wiggle room” – range of prices that might be defendable if audited.

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- They also spend a lot of effort defending their positions when audited.
- Introducing penalties should cause MNEs to set their transfer prices closer to the arms-length standard, and thus lower the value of the firm by decreasing its profits.
- The penalty discourages transfer price manipulation and reduces the MNEs' market value.
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  – Transfer pricing = the pricing of products traded between affiliated firms
  – Because the prices are set by the firms involved, there are opportunities for MNCs to manipulate the prices to evade government regulations such as customs duties and corporate income taxes.

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• To curtail these opportunities for evasion, most governments have adopted transfer pricing regulations based on the OECD 1995 guidelines.
• These guidelines require MNCs to follow the arm’s length principle, i.e. must price each intrafirm transaction as if it had occurred between two unrelated parties negotiating for the same product under the same circumstances (IRS 1994).
• Transfer pricing is the most contentious issue in international taxation due to the difficulties involved in setting arm’s length prices acceptable to both tax authorities and MNCs.
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• Comparable transactions between unrelated parties are often not available for intrafirm transactions in goods, much less for intangibles and services.
• As MNCs move business services offshore, they must develop transfer pricing policies for pricing these intrafirm transactions.
• Both home and host governments must apply the arm’s length standard to these transactions.
• Transfer-pricing regulations for services are much less developed than for goods and raw materials.

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• MNCs are expected to follow the benefit-cost principle with little explicit guidance as to acceptable methodologies compared to the detailed guidelines available for goods transactions.
• Transfer-pricing policies for technical and administrative/managerial services are especially vulnerable to government audit.
  – MNCs have little documentation to justify their transfer pricing policies for administrative or managerial services.
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• Shift in international trade and FDI toward services.
• Increased privatization of state-owned enterprises in service industries such as telecommunications, electricity and postal services has encouraged inward FDI,
  – particularly in Latin America and Central and Eastern Europe.
• Information technology has enabled the disassembly of service processes into distinct activities that can be placed in separate firms in physically distant locations.

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• MNCs in the manufacturing sector are setting up foreign affiliates to provide support functions for the corporate group;
  – financial, trading and marketing affiliates.
• Information technology enabled services, providing back office and support functions (payroll, order fulfillment) and front office functions (customer care), are being relocated to developing countries such as India and the Philippines.
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- Many countries are working on providing clearer guidance for the pricing of services within MNCs.
- The United States Treasury has proposed new transfer pricing regulations designed to harmonize transfer-pricing methodologies for pricing intrafirm services with already existing rules for goods.
- Proposed policy changes appear to be motivated by the rapid expansion of international intrafirm trade in business services, and the rising knowledge intensity of production.

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- A typical teleservices MNC provides a full range of call services to third party clients (e.g. Dell, UPS).
- The firm owns one or more foreign affiliates that deliver call centre services to customers of these third party clients.
- This article explores the facts and circumstances of this rapidly growing industry and uses economic analysis to develop transfer-pricing rules for the offshored call centers.
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• Business service operations in industries such as telecommunications, transportation and health care, and business process operations such as human resources management, call centers and check processing, are moving offshore.
• The occupations most at risk of international outsourcing from the United States include office support, business and financial support, computer and math professionals, paralegals and legal assistants, diagnostic support services and medical transcriptionists,
  – represents 11% of the US work force in 2001.

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• The movement offshore is primarily driven by the location savings that countries like Ireland, Canada and India can offer relative to costs in the United States.
• Factors encouraging offshoring from the United States are cost savings, availability of English-speaking graduates, good information technology (IT) infrastructure, and a favorable government attitude towards FDI and international trade.
• In e-services such as call centers, data entry and software engineering, physical proximity is not necessary for efficient and effective delivery.
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• The recent movement to international offshoring of such activities, initially to Canada and more recently to India, is a new version of the old-style offshoring of low-skilled manufacturing jobs to export processing zones.

• India, Canada, Mexico and Brazil appear to have an edge over other appealing options such as Ireland.
  – Each country has relative strengths and weaknesses that can lead to different country locations being chosen based on details.

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• Inbound teleservices include product service and support, response to customer inquiries and order processing.

• Outbound teleservices include direct sales, product inquiry, and appointment setting.
  – These services are designed to improve the overall customer experience and build closer relationships between companies and their customers.
  – Outbound services are shrinking, largely due to government “no call” regulations that prohibit firms from making unsolicited calls in the United States.
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- The parent firm's activities are of two types: support activities, and activities both upstream and downstream from the call centre stage of production.
- The activities of the call centre affiliates are determined by the teleservices parent firm, with all risks (credit, market, foreign exchange) and responsibilities typically being assumed by the parent firm.
- Intangibles are sources of competitive advantage, along with reputation and brand name.

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- Support activities provided by the parent firm can include:
  - strategic management (at the corporate and business strategy levels),
  - finance and administration (e.g. all forms of overhead administration and finance, including foreign exchange transactions) and
  - technology development,
- Firms must either develop their own proprietary software (a production intangible) or purchase it from other firms.
  - In-house process technologies likely to be proprietary.
  - Teleservices firms normally have their own information technology systems involving designing of programs and scripts, network management, call routing and data retrieval, and quality control.