A Further Examination of Income Shifting Through Transfer Pricing Considering Firm Size and/or Distress

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Abstract: This study evaluates the effect of firm size on income shifting between tax jurisdictions through the use of transfer prices both before and after the passage of the Tax Reform Act of 1986 (TRA86). Prior research addressing income shifting through transfer pricing analyzes larger, financially sound firms. This empirical study extends the transfer pricing literature by including smaller and in some cases financially distressed firms in the sample and testing the effect by firm size on income shifting. Our findings suggest that smaller and/or distressed firms are less likely to shift income through transfer pricing than larger firms.

When income is taxed at different rates in different countries, multinational enterprises are typically concerned with the allocation of income to the various countries. Income shifting policies in multinational companies are increasingly recognized as important given the rapidly changing economic and sociopolitical environment. Many multinational enterprises engage in income shifting policies that attempt to maximize profits while minimizing taxes. Various methods are available to multinational firms to shift income from one jurisdiction to another. In most multinational firms, goods and services are routinely transferred among related entities in different tax jurisdictions. The prices at which these goods and services are transferred (transfer pricing) can have a significant impact on global taxes. The most popular methods of shifting income include the location of debt, rent on leases, royalties on licenses, and transfer pricing (Scholes and Wolfson, 1992). A number of research studies address issues surrounding the use of different methods for shifting income between foreign jurisdictions. These studies evaluate such issues as whether changes in international tax rates, country specific regulations (tax/tariff/customs), and the flexibility of the firm to react to changes influence income shifting.

As discussed in the section “Literature Review,” recent empirical research (Harris, 1993; Klassen et al., 1993; Cravens and Shearon, 1996; Jacob, 1996) explores the
consequences of international transfer pricing policies; concentrating on the enterprise wide effects of transfer pricing policies and tax law changes. This research addresses the question of whether firms with subsidiaries facing lower foreign tax rates shift income out of the US while those facing higher foreign tax rates shift income into the US. Harris (1993) finds evidence of income shifting in various degrees, for certain types of firms, into the US after enactment of the Tax Reform Act of 1986 (TRA86). (TRA86 reduced the highest marginal tax rate in the US from 46% to 34%.) This line of inquiry was extended by Jacob (1996) who hypothesized that the 1986 US tax law change would be accompanied by an increase in intrafirm transfers in order to shift income using transfer pricing policies. This study extends the income shifting literature by examining the impact of firm size on income shifting using transfer pricing. We extend the work of Jacob (1996) by including smaller firms in the sample and analyzing the impact of firm size on income shifting through transfer pricing policies.

Our findings show that Jacob’s results change when the smaller firms are included, suggesting that smaller and/or distressed firms with missing COMPUSTAT data are less likely to shift income through transfer pricing than larger firms. Analyzing the results by size deciles suggests that firm size has some influence on the use of transfer pricing to shift income. Our results indicate that prior to TRA86, only the largest firms (decile 10) used transfer pricing to shift income in order to reduce global taxes. After TRA86, a broader group of firms with intrafirm transfers (firms in deciles 2, 4, 6, and 8) appear to use transfer pricing policies to shift income to reduce global taxes.

Research investigating the effect of firm size on income shifting is important for several reasons. First, it provides evidence regarding what types (size) of firms are most likely to income shift. Given the concern in the US that the US receives too small a share of income taxes on worldwide income, this information may help direct the US transfer pricing policy enforcement efforts. Second, if the ability (or willingness) of firms to react to changes in tax rates varies by size, then Congress should consider these differences in determining the potential revenue impact of tax law changes. Third, it provides some indirect evidence on the potential trade-offs between tax and non-tax factors in reporting profits. Shifting profits geographically can have implications for internal performance evaluation and incentives of managers in different countries as well as the level of investment in foreign locations. In addition, to the extent users of financial statements cannot distinguish the tax-planning impact on reported profits by geographic segment from real changes in underlying profitability, significant non-tax costs can arise if geographic data is used to draw inferences about firm value.

The remainder of the article is organized as follows. The next section reviews previous research investigating transfer pricing and database errors. This is followed by the section on the development of the hypotheses and next to that is the section that contains the research methodology. The section that discusses the research results follows next and the last section summarizes the conclusions.

LITERATURE REVIEW

TRA86, with the lowering of the US corporate tax rate from 46 percent to 34 percent, created tax incentives for US multinational firms to shift income into the US. While tax
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