

# International Transfer Pricing: Searching for Patterns

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International transfer pricing is pervasive in that it can apply to all manner of goods, services, finance and intangible assets which flow between members of a group located in different parts of the world. Fiscal authorities in many countries are modernising their legislation to ensure they collect a fair amount of corporate tax revenue from companies operating within their jurisdiction. However, draconian tax rules may adversely affect world trade and reduce foreign direct investment.

Jamie Elliott and Clive Emmanuel report on an exploratory fieldwork study of 12 multinational enterprises based in the UK which attempts to place current practices of international transfer pricing in the organisational and fiscal context. One emerging pattern appears to associate industry sector affiliation with preferred transfer pricing method.  
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International transfer pricing (ITP) is the monetary value attaching to goods, services and intangibles traded between units of the same group which cross national boundaries. The annual value of such transactions is extremely difficult to gauge but in the mid-1990s, UNCTAD (1997) estimated there were 44,500 MNEs world-wide with 275,000 foreign affiliates. In 1994, the assets of all foreign affiliates were placed at \$8.4 trillion: annual foreign direct investment in 1996 was \$350 billion, the UK being the second largest outward investor (\$54 billion) at that time. As a consequence, the intra-group cross-border transactions in total constitute a significant proportion of world trade which in some industries is even more pronounced. For example, the percentages of intra-group to all cross-border trade in automotive parts, pharmaceuticals, computing and electronics are estimated, to be in excess of 50 per cent of all exports in these sectors (Dunning and Pearce, 1985).

Consistent with the world-wide trend, UK transfer

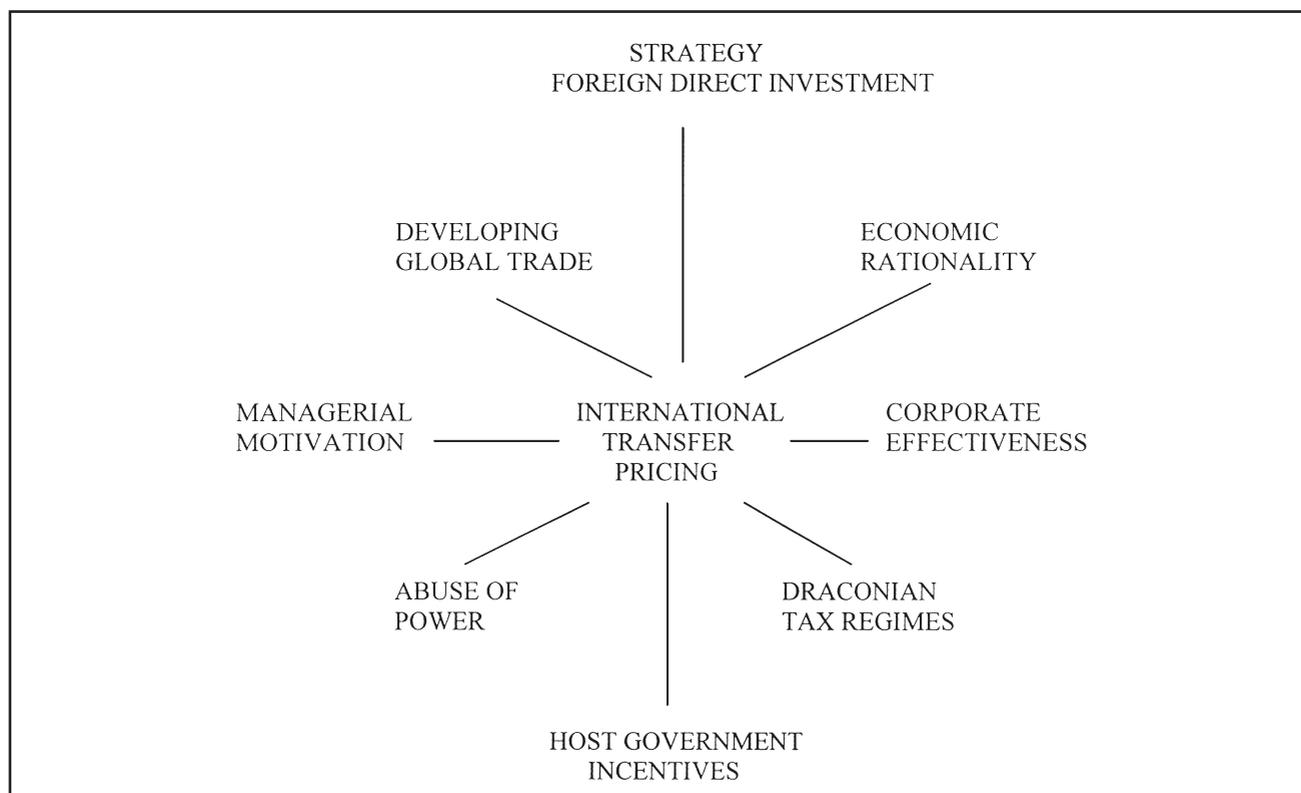
pricing legislation is currently being modernised. For accounting periods ending on or after 1 July 1999, transfer pricing falls within the corporate tax self-assessment system which means tax payers must be able to demonstrate the use of arm's length prices. Arm's length prices include not just transaction-based methods, like comparable uncontrolled price, resale price minus and full cost plus but also profit-based methods such as the transactional net margin method (TNMM), and the profit split method. Other changes include the introduction of advance pricing agreements (APAs), which encompass sophisticated risk – return profiles within functional analysis, increased power to penalise non-compliance, and increased documentation requirements.

For management accountants, ITP resurrects the thorny issues of cash flow management, the funding of investments overseas, the evaluation of subsidiaries and their managers, and effective tax management. Within this arena, marketing specialists, behavioural scientists, corporate strategists, tax lawyers, brand lawyers, economists and consultants can all claim a legitimate perspective on ITP. It is of little wonder that academic researchers have not produced a universally acceptable theory of ITP.

## The Conundrum

International transfer pricing can be viewed from many perspectives and involves a series of tensions both within and external to the multinational enterprise. Figure 1 displays some of these.

Numerous surveys have been conducted which, over a 40-year period, have failed to uncover explanations of practice or to reveal patterns of association between ITP and multifarious variables (Borkowski,



**Figure 1 Tensions in International Transfer Pricing**

1996). One of the problems relates to the differing focus each survey has adopted. For example, is ITP addressed as the typical, on average or most frequently used process for transactions within the group, inter-subsidary or between headquarters and subsidiaries? More recently, in the USA especially, research to detect evidence of income shifting has been undertaken using financial accounting databases or confidential tax data. The dominant influence of tax is the prior assumption on which these studies are based and alternative explanations of ITP in practice are largely ignored.

Theoretical frameworks suggested by Eccles (1985); Spicer (1988); Colbert and Spicer (1995) are confined to domestic transfer pricing situations. Nevertheless, the focus on transaction costs which the latter authors in particular have offered, prompted this current study which places emphasis on one specific intra-group transaction which crosses national boundaries. Patterns which emerge at this micro-level of analysis may provide insights into ITP in the MNE or possibly, industry sector. The aim of the study seeks to place ITP in an organisational and fiscal context in order to detect patterns in current practice.

### Exploratory Fieldwork

Each participant was asked to describe ITP for an individual, specific cross-border intra-group transaction of their choice. The fieldwork therefore

involved face-to-face interviews which were subsequently fed back by means of reports for authentication and accuracy. The intention was to gain in-depth understanding of the single transaction whilst recognising that other transactions within the same MNE may not share the same ITP process or methods. Great caution must therefore apply to any apparent general comments emanating from the study.

The 12 participating MNEs were not selected randomly. All 12 indicated a willingness to discuss ITP in an earlier survey (Elliott, 1998) and for this reason, the views expressed are those offered by tax managers or directors of MNEs. The normal conditions of anonymity apply. The fieldwork therefore relates to five MNEs in financial services, four MNEs, whose main activities are the manufacture and supply of products, and three MNEs whose main activities are the provision of services. In all but one case, the participants chose to describe a specific transaction relating to main activities. The parent company is located in the UK in five instances and in the USA for seven of the MNEs. In terms of annual turnover, the 12 MNEs lie in a range from less than £100 m to over £5 bn; in fact, half are in the over £5 bn category.

The questionnaire responses to the earlier survey allowed the researchers some familiarity with each MNE's ITP policies. A protocol was developed to prompt participants to place the specific ITP they had chosen to describe in context. This included broad questions on organisational structure, implemen-

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