Journal of Economics and Business 65 (2013) 1–13

Contents lists available at SciVerse ScienceDirect

Journal of Economics and Business

The arm's length principle, transfer pricing, and location choices

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ARTICLE INFO

Article history:
Received 23 March 2012
Received in revised form 26 July 2012
Accepted 24 September 2012

JEL classification:
F23
L13
H26
H32

Keywords:
Transfer price
The arm's length principle
Tax
Location choice

ABSTRACT

This paper examines the impacts of the arm's length principle on tax revenues under endogenous location choices. The results show that the level of transfer price depends not only on taxation policies, but also on firms' location choices. An imposition of the arm's length principle on a multinational enterprise does not raise tax revenues under endogenous location choices. Such a result is in contrast to the common opinion of tax authorities regarding the regulation on transfer pricing.

1. Introduction

The trend of increasing globalization in the world economy has created many new multinational enterprises (hereafter, MNEs) and has also increased the amount of cross-border transactions between their affiliates or related companies. Such transactions often involve the issue of transfer pricing. Transfer pricing is the pricing of internal transactions between subsidiaries or related companies, serving as an important device for a MNE to achieve the goal of maximizing global profits. Nevertheless, tax authorities often claim that transfer pricing deprives governments of their fair share of taxes from global enterprises (Neighbour, 2002). They presume that MNEs use transfer pricing policies to

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[1] Thanks to financial support by the National Science Council of the Republic of China under Grant NSC-96-2415-H-030-003. I also thank Fu-Chuan Lai, Shin-Kun Peng, and Yan-Shu Lin for insightful suggestions.

0148-6195/$ – see front matter
http://dx.doi.org/10.1016/j.jeconbus.2012.09.004

shift profits from high-tax rate countries into low-tax rate countries. To avoid the corresponding loss in tax revenues, tax authorities constantly tighten rules to curb transfer price distortions. From the perspectives of maximizing tax revenues, necessary tax codes must be enacted to prevent such quasi tax savings. As a result, most countries have rules or regulations to assess the appropriateness of the transfer prices quoted by MNEs.

One way to restrict the use of transfer pricing is via an audit, which follows the arm's length (hereafter AL) transaction principle. The AL principle is the principle associated with a transaction where the affiliates are dealing from an equal bargaining position, neither party is subject to the other's control or dominant influence, and the transaction is treated with fairness and legality. If the transfer price is judged to be significantly different from the arm's length price, then national tax authorities will correct the transfer price accordingly.[2] This concept can be found in Article 9 of the OECD Model Tax Convention, which forms the basis of many bilateral tax treaties. Whenever two countries have a treaty in place that contains an Associated Enterprises (or equivalent) Article worded in a manner similar to Article 9 of the OECD Model, that article will be interpreted in line with internationally accepted transfer pricing principles. This says that those principles will set the boundaries for the application of the transfer pricing rules in the domestic legislation of the Contracting States.

The same concern regarding regulations on transfer pricing is also found in the U.S. The purpose of Internal Revenue Code (IRC) section 482 is "to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent the avoidance of taxes with respect to such [internal] transactions." The AL regulation of IRC 482 requires the calculation of a firm's transfer pricing to be comparable to a transaction with an independent party. If the transfer price reported by the firm deviates too far from the tax authorities' expectation, then the firm may face a penalty. The penalty could be either 20% or 40% of the underpaid amount of tax, with a higher penalty applicable when the deviation from the penalty threshold is larger, according to IRC §6662. In some countries like Argentina, the amount of the penalty may be up to 400% of the underpaid tax (Ernst & Young International Ltd, 2012).

The AL principle is usually applied by comparing the 'conditions' (e.g. price or margin) of a controlled transaction with those of independent transactions. The OECD has set forth a series of accepted methodologies according to Transfer Pricing Guidelines (1995). They are the comparable uncontrolled price (hereafter CUP) method, cost-plus (hereafter CP) method, resale price method, profit split method, and transactional net margin method. Among these methods, the CUP and the CP methods are the two mostly frequently used regulation rules (Ernst & Young International Ltd, 2010).

Under CUP, the tax authorities constrain the MNEs to set their transfer prices to the price of a comparable uncontrolled transaction with an independent firm. On the other hand, under CP the tax authorities compute the transfer price by applying an 'appropriate' margin to the cost of MNEs. The CUP method is equivalent to the CP method in a competitive market, because the price of an independent firm selling locally as the comparable uncontrolled price and the average mark-ups of firms selling locally as the cost plus mark-up are the same. Under this situation the OECD transfer pricing rules can be studied under the same framework.

The AL principle is usually translated into marginal cost pricing in the literature (Kind, Midelfart, & Schjelderup, 2005; Peralta, Wauthy, & van Ypersele, 2006). This is because in order to detect deviations from AL pricing in practice, tax authorities test whether a transfer price meets the AL standard by comparing data from the audited firm to data from comparable transactions between independent buying and selling firms. The general idea is that as long as the audited firm cannot influence the comparable transactions, then the data from either the CUP or the CP method should approximate the independent price of a competitive market. This situation implies that in a competitive market the AL principle can be proxied by marginal cost pricing.

In the literature of international transfer pricing it is well known that a MNE facing different national tax rates can potentially shift profits to low-tax countries by manipulating transfer prices on intra-firm traded goods; see e.g. Copithorne (1971) and Horst (1971). There are two crucial assumptions in the

[2] According to Ernst and Young's (2010) transfer pricing survey, many countries are introducing or revising tax laws governing transfer pricing, including documentation requirements or enacting penalties for transfer pricing adjustments, and are using transfer pricing audits to enforce their AL regulation laws.