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Transfer pricing rules and corporate tax competition

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Abstract

A multinational parent sells a non-marketed commodity to a foreign subsidiary that uses the product as an input to produce a product it then sells. The subsidiary is controlled by a local managing partner whose compensation consists of a lump-sum payment plus a share of the subsidiary's profit. The parent chooses an optimal transfer price taking into account incentives for the subsidiary's managing partner and taxes. Home and host governments impose corporate income taxes on the parent and subsidiary's respective profits subject to a transfer pricing rule (e.g. cost plus price method or comparable profit method). A Nash equilibrium is derived for effective tax rates chosen by home and host governments. We then examine harmonization and suggest that tax rates would be reduced.

Keywords: Corporate taxation; Transfer pricing

1. Introduction

Recently, there have been changes made to U.S. transfer pricing rules (Section 482 of the U.S. Income Tax Act) resulting from an expressed concern over the low payment of corporate tax by foreign companies in the United States. Several papers pointing towards low profits being earned in the United States have been influential in providing empirical support for a tightening up of transfer pricing rules (e.g. Harris et al., 1993, and Grubert et al., 1993). Moreover, other high tax countries have also become more concerned about the potential shift of taxable income out of their jurisdiction (see, for example, *Tax Notes International* 6(23), 7 June, 1993, 1359).

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Policy-makers often view transfer prices as being manipulated by multinationals to minimize taxes. Transfer pricing rules in many countries assume that the correct price to assess for non-marketed transactions is a comparable price of a similar arm's length transaction adjusted for quality and other differential attributes such as business risk (see Bernard and Weiner, 1990; Eden, 1985). The rules may require the use of a number of different methods for calculations. In many cases there is no similar transacted priced that can be used. Instead, as in the United States where the development of transfer pricing rules has become an art, several alternative methodologies have been prescribed when there is no comparable uncontrolled price: (i) the resale price method, (ii) the cost-plus price method and, most recently, (iii) the comparable profit measure.[1] The implication of these methods used to measure transfer prices is that the company cannot use the actual transfer price to measure sales or costs. Instead, some 'objective' measure must be used that adjusts the sales or costs of the firm for anticipated profiles earned in the past by firms in a similar line of business activity.

This view, that true transfer prices are essentially based on sales or costs of production (with an adjustment for an assumed profit rate), fails to recognize the role of transfer prices in influencing the behaviour of subsidiaries that are controlled by the parent.[2] As recently emphasized in the accounting literature (Ronen and Balachandran, 1988; Jordan, 1989; Amershi and Cheng, 1990; Halperin and Srinidhi, 1991; Datar and Banker, 1991), the transfer price may be used as part of an incentive scheme to induce divisions to improve their efficiency. If control is an issue, the transfer price need not be equal to the marginal cost of production since it influences the agency costs faced by the parent when controlling subsidiaries. Therefore, transfer pricing by multinationals may be used not only to minimize taxes but also to improve the efficiency of worldwide operations.

In this paper we model a multinational parent operating in a home country (e.g. Japan) that sells a non-marketed commodity only to a subsidiary operating in a foreign country. The subsidiary uses the commodity as an input to produce a product that is only sold in a competitive market of a host country (e.g. the United States). The subsidiary, which operates under decreasing returns to scale, uses a fixed intangible input provided by the multinational parent. Moreover, the subsidiary is controlled by a local managing partner whose effort in the subsidiary is rewarded by a portion of the profits earned by the subsidiary plus a lump-sum transfer. The parent

[1] See the review by Horst (1993) on the U.S. rules.

[2] For example, Granfield (1993, p. 100) has recently noted that: "The vertically integrated MNC (multinational corporation) can also achieve greater profits than two arm's length firms performing similar functions simply by appropriately structuring the internal, to MNC, transfer prices."