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Tax strategy control: The case of transfer pricing tax risk management

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ABSTRACT

This paper examines how a functional tax strategy impacts the management control system (MCS) in a multinational enterprise (MNE) facing transfer pricing tax risks. Based on case study findings it is argued that the MCS in a multinational setting is contingent upon the MNE's response to its tax environment. Moreover, the paper extends existing contingency-based theory on MCS by illustrating the role of inter-organisational network collaboration across MNE transfer pricing tax experts. This collaboration, caused by a widely dispersed tax knowledge base, fuels the formal interactive control system and reduces tax uncertainty. The paper adopts an interdisciplinary approach for explaining findings, using contingency-based theory and network theory at the inter-organisational level.

1. Introduction

This paper addresses how a tax strategy influences the management control system[1] (MCS) in a tax compliant multinational enterprise (MNE) facing transfer pricing tax risks.[2]

Recent studies (Cools et al., 2008; Cools and Slagmulder, 2009; Deloitte, 2007; Oosterhoff, 2006; Wunder, 2009) indicate that international transfer pricing is the primary tax risk management topic in multinational enterprises (MNEs). Transfer pricing risks are a consequence of uncertainty[3] in the tax environment surrounding MNEs (Eden et al., 2005; Mills et al., 2010). This uncertainty primarily relates to ambiguous transfer pricing regulations and inconsistency in the way different tax jurisdictions apply the arm's-length principle when examining MNEs' transfer pricing practices (Eden et al., 2001; Oosterhoff, 2006; Picciotto, 1992). As the volume of intra-group trading in MNEs is considerable (UNCTAD, 2003; U.S. Department of Commerce, 2011), tax risks linked to international trans-

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[1] The MCS literature offers several definitions and discussions as to what constitutes MCS (Abernethy and Chua, 1996; Anthony, 1965; Chenhall, 2003; Emmanuel et al., 1990; Green and Welsh, 1988; Langfield-Smith, 1997; Merchant and Van Der Stede, 2007; Simons, 1994). In this paper, Simons' definition of MCS is applied; this definition suggests that MCS are 'the formal, information-based routines managers use to maintain or alter patterns in organizational activities' (Simons, 1994, p. 5).

[2] The term 'risk' refers to unpredictability in corporate outcome variables (Miller, 1992) and hence covers downside as well as upside risks. Transfer pricing risks normally concern double taxation risks and reputational risks. Double taxation risks relate to a situation where tax authorities in one tax jurisdiction adjust the transfer prices used by a local MNE entity and a corresponding adjustment is denied. In this case, the same income will be taxed twice. Reputational risks relate to a situation where an MNE's reputation is negatively impacted in case of a public announcement of a transfer pricing audit adjustment. Hence, transfer pricing risks are usually considered as potential *downside* deviations from expected organisational performance, although upside transfer pricing risks do exist. One example is when an MNE entity receives an upward adjustment on a negative taxable income and the corresponding entity has a positive taxable income and is not located in a tax haven. In this case, the net tax effect of the adjustment at group level is positive.

[3] The term 'uncertainty' refers to the unpredictability of environmental or organisational variables that impact organisational performance (Miles and Snow, 1978), or the lack of desired information about such variables (Galbraith, 1977). Uncertainty about environmental and organisational variables reduces the predictability of corporate performance and hence increases risk (Miller, 1992).

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fer pricing have become significant and should be properly managed.

While a few studies have examined tax regulation effects on transfer pricing practices in MNEs (e.g. Borkowski, 2001, 2008, 2010; Cools et al., 2008; Cools and Slagmulder, 2009; Plesner Rossing and Rohde, 2010), these studies have not explicitly investigated how MNEs attempt to reduce tax uncertainty linked to international transfer pricing and the way MCSs can be employed and used for this specific purpose. Such studies are relevant, as they may improve the current literature's limited understanding of how MNEs apply MCS for tax risk management purposes and assist top managers in practice in their search for ideas to manage tax risks. Consequently, this paper seeks to answer the research question:

How does a functional tax strategy influence the management control system in a multinational enterprise facing transfer pricing tax risks?

The present paper responds to recent calls for studies of organisational risk management practices and the way MCS can be used for this purpose (Arena et al., 2010; Bhimani, 2009; Hagigi and Sivakumar, 2009; Woods, 2009), including the role of inter-organisational networks for risk management and strategic control (Chua and Mahama, 2007; Hopwood, 1996; Miller et al., 2008). It contributes to the contingency-based school of accounting research, which investigates how and to what extent management accounting and control systems are contingent upon organisational and environmental circumstances (e.g. Borkowski, 1990, 1992a,b, 1997; Chenhall, 2003; Cools et al., 2008).

Also, the paper aims at integrating accounting and taxation disciplines, as called for in recent literature reviews (e.g. Dykxhoorn and Sinning, 2010; Hanlon and Heitzman, 2010; Shackelford and Shevlin, 2001). So far, these two academic disciplines have tended to be treated separately in the literature, in spite of the close relationship that exists between them.

In a practical sense, this paper responds to recent calls for MCS research that focuses on providing research insights and results that are useful to corporate managers in real-life situations (e.g. Baldvinsdottir et al., 2010). International transfer pricing remains at the top of the tax risk management agenda in MNEs (Wunder, 2009), and hence contributions that may assist practitioners in their search for ideas on how to align their practices with an increasingly uncertain and ambiguous tax environment are required.

The paper is structured as follows: Section 2 presents the MNE tax environment. Section 3 presents the contemporary transfer pricing literature and this study's theoretical frame of reference. Research strategy and design are described in Section 4, and Section 5 presents the case analysis and results. Section 6 discusses case results, and Section 7 presents the conclusions of the study.

2. Tax environment

The increase in MNE intra-group trading over the past decades has presented tax authorities and regulators with new issues and increased complexity, resulting in the area of international transfer pricing becoming a centre of primary attention. The reason is that corporate tax rate differentials have offered MNEs the opportunity to use international transfer pricing for profit accumulation in low-tax jurisdictions (Eldenburg et al., 2003; Rahman and Scapens, 1986). Consequently, a number of initiatives have been established with the purpose of encouraging MNEs towards behaviour that represents market behaviour, in order to ensure that each tax jurisdiction hosting MNE activities receives a fair share of the total value creation (Picciotto, 1992). The initial attempt to encourage such behaviour was made when the OECD issued the OECD Transfer Pricing Guidelines in 1979. In 1994, the US tax authorities launched their own regulatory standards (IRS, 1994), which were followed by the OECD's 1995 revision (OECD, 1995) of the 1979 Guidelines and subsequent additions to those revised Guidelines (OECD, 1996, 1997, 1999, 2010). Since then, a number of countries worldwide have implemented local regulations,[4] mostly in line with the OECD Guidelines (Cools et al., 2008, p. 605). While some differences exist in local regulations (Cools and Emmanuel, 2007; Deloitte, 2007; Ernst & Young, 2009), the arm's-length principle in the OECD Model Tax Convention Article 9 (OECD, 1992) continues to be a fundamental concept in the global regulation of international transfer pricing. The arm's-length principle basically establishes that when divisions or business units in an MNE engage in intra-group transfers of goods, services and intangibles, they should price such transfers according to the price that would have been set if the transfer had taken place between independent parties. While this principle seems straightforward, its application in practice entails numerous problems and challenges, as market prices for intra-group transfers, due to their idiosyncratic nature, rarely exist (Chan and Chow, 1997; Collins and Shackelford, 1998; Oyelere and Emmanuel, 1998). Also, transactions that appear similar are often financially different in terms of underlying facts and circumstances (Chan and Lo, 2004, p. 97; Eden et al., 2005). As stated in the OECD Guidelines, 'transfer pricing is not an exact science' (OECD, 2010, p. 29). Instead, it often builds on judgments made from both MNE and tax authority perspectives on how the arm's-length principle can be applied and documented in concrete and often complex situations, since the MNE value chain often lacks a sufficient degree of transparency. In addition to the ambiguity that the arm's-length principle constitutes in itself, tax authorities in different countries tend to differ in both regulatory standards of international transfer pricing (Cools and Emmanuel, 2007) and the way such standards are to be interpreted and applied by MNEs (e.g. Oosterhoff, 2006). This contributes to MNE uncertainty as to what

[4] According to KPMG International (2011), more than 60 countries worldwide have instituted laws and regulations regarding transfer pricing.

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