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The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness

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ABSTRACT

In conventional accounting literature, 'transfer pricing' is portrayed as a technique for optimal allocation of costs and revenues among divisions, subsidiaries and joint ventures within a group of related entities. Such representations of transfer pricing simultaneously acknowledge and occlude how it is deeply implicated in processes of wealth retentiveness that enable companies to avoid taxes and facilitate the flight of capital. A purely technical conception of transfer pricing calculations abstracts them from the politico-economic contexts of their development and use. The context is the modern corporation in an era of globalized trade and its relationship to state tax authorities, shareholders and other possible stakeholders. Transfer pricing practices are responsive to opportunities for determining values in ways that are consequential for enhancing private gains, and thereby contributing to relative social impoverishment, by avoiding the payment of public taxes. Evidence is provided by examining some of the transfer prices practices used by corporations to avoid taxes in developing and developed economies.

Transfer pricing[1] is of increasing importance to corporations as in a globalized economy their operations extend to countries with diverse taxation regimes and regulatory capacities. The pursuit of profits, cash flows, marketing goals, economies of scale and competitive advantage through divisionalization, joint ventures, subsidiaries and affiliates necessitates estimations of costs to measure performance and taxable profits. In such an environment corporations need to develop processes for allocating costs and overheads and design strategies for estimating transfer prices for goods and services. Since costs and overhead allocation mechanisms are highly subjective corporations enjoy considerable discretion in allocating them to particular products/services and geographical jurisdictions. Such discretion can enable them to minimise taxes and thereby swell profits by ensuring that, wherever possible, most profits are located in low-tax or low risk jurisdictions. Experts acknowledge that transfer pricing can enable companies to avoid double taxation, but "it is also open to abuse. It can be used to shift profits artificially from a high- to a low-tax jurisdiction, by maximising expenses in the former and income in the latter" (PricewaterhouseCoopers, 2009, p. 15). A former Senior Fellow of the Brookings Institution has argued that "transfer pricing is used by virtually every multinational corporation to shift profits at will around the globe" (Baker, 2005, p. 30).

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[1] In textbooks (e.g. Horngren et al., 2002; Atkinson et al., 2004) 'transfer pricing' is commonly understood as the price that a company charges for a product, service, loan and the use of intangibles to a related organisation, including a division, subsidiary, affiliate or a joint venture. It acts as a device for the allocation of costs, income, revenues and profits to various subunits. Traditional views conjure up images of transfer prices in relation to tangible goods and services. Yet, in a world where executives are under pressure to produce higher shareholder value, transfer prices, and the associated opportunities to construct them in tax-minimising manner, may cover leasing, intellectual property, royalties, interest payments, expenses, fees, management charges, advisory services and virtually everything that a company can buy or sell.

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The mobilization of transfer pricing for tax avoidance,[2] and sometimes evasion, is largely invisible to the public and is difficult and expensive for regulatory authorities to detect. There is indeed a complex game involving numerous actors—corporations, accountants, lawyers, consultants, governments, tax authorities, multinational agencies (e.g. OECD), NGOs and so on—engaged in establishing and revising the rules of the game with regard to which method(s) of calculating prices is acceptable, and also developing and detecting ways of manipulating, escaping or subverting these rules and methods. As means of enhancing divisional, segmental, product and global profits, the unimpeded use of transfer pricing matters to stock markets as earnings, dividends, share prices and return on capital are all affected. It also matters to company executives because their financial rewards are frequently linked to corporate earnings. Transfer pricing practices matter to the state because they affect the taxes that it can levy upon corporate profits to finance public goods and thereby secure legitimacy.

Business advisers claim that "transfer pricing continues to be, and will remain, the most important international tax issue facing MNEs" (Ernst & Young, 2006, p. 5). This is entirely plausible because transfer pricing enables corporations to minimize tax payments by enabling capital to be exported to more favourable locations. It has become a major growth area for international accountancy firms which market "creative and practical solutions for . . . transfer pricing needs" (Ernst & Young, 2005, p. 68). Given the importance of transfer pricing in relocating corporate profits, facilitating tax avoidance and the flight of capital, and its implications for the distribution of wealth and public goods (US General Accounting Office, 1995; Armstrong, 1998; Oyelere and Emmanuel, 1998; Gramlich and Wheeler, 2003; Baker, 2005; UK Africa All Party Parliamentary Group, 2006), the Head of the US Inland Revenue Service (IRS) has described transfer pricing as "one of [its] most significant challenges" (The Times, 12 September 2006). Arguably, there is significantly more to transfer pricing than refinements of techniques and a study of US corporations concluded that "transfer pricing may be playing an important role in aggregate national accounting, potentially reducing the reported value of exports and the current account (and thus GDP). The response of the price wedge to tax rates indicates that tax minimization may be an important part of transfer pricing decisions with consequences for the level of corporate tax revenue and strategic responses to changes in the tax code" (Bernard et al., 2006, pp. 19–20).

With the intensification of globalization, nation-states have become concerned about the malleability of 'transfer prices' and their role in avoiding taxes and knock on effect for public legitimacy and citizens' life-chances. Some have taken considerable powers to challenge corporate calculations. For example, the US tax authorities have considerable powers under Section 482 of the Internal Revenue Code to allocate income, deductions, credits, or other allowances between or among controlled entities if that allocation is considered to be necessary to prevent evasion of taxes. Nation-states and transnational agencies have also developed joint frameworks, treaties and international guidelines on the formulation of transfer prices (Organisation for Economic Co-operation and Development, 1979, 2009; European Commission, 2004; Eden et al., 2001). Faced with a squeeze on budgets and concerns about social and political stability some states are showing greater interest in scrutinising the effect of transfer pricing on corporate taxes (Hansard, UK House of Commons Debates, 6 Jul 2006, col. 1258; US Government Accountability Office, 2004). Some have sought to curb abuses by imposing higher financial penalties and by beefing up audit and enforcement requirements (Williamson et al., 2001; Eden et al., 2005). Corporate executives acknowledge that "the likelihood of being challenged by tax authorities on their transfer pricing [practices] was increasing" (Henderson Global Investors, 2005a, p. 4) and a number of companies are facing lawsuits from the tax authorities and have been persuaded to make financial settlements. The UK authorities made transfer pricing adjustment to 1724 tax computations in 2005–2006 and [unknown] penalties were agreed in five cases (Hansard, UK House of Commons Debates, 6 Jul 2006, col. 1258). For the period 2003–2007, transfer pricing adjustments resulted in additional tax revenues of £1134 million (Hansard, UK House of Commons Debates, 10 November 2008, col. 938) and a further £2114 million was raised from adjustments for the period 2007–2009 (Hansard, UK House of Commons Debates, 11 January 2010, col. 781). Transfer pricing audits have enabled the Australian tax authorities to raise more than A$2.5 billion in additional tax revenue in the 5 years to 2005 (Sydney Morning Herald, 31 August 2006).

In response to the uncertainty and risk to which corporations are exposed by transfer pricing, in almost all countries, there are possibilities of avoiding protracted disputes with tax authorities through 'Advance Pricing Agreements' (APA). These permit corporations and domestic and foreign tax authorities to agree on transfer pricing methods in advance of filing a tax return and thus avoiding considerable uncertainties and possible lawsuits (Organisation for Economic Co-operation and Development, 2001, 2009; US Internal Revenue Service, 2007). For confidentiality reasons, tax authorities are unwilling to publish details, but some available evidence suggests that relatively few agreements (For UK evidence see Appendix 1) are entered into (Williamson et al., 2001). In turn, this suggests that corporations are inclined to regard the area of transfer pricing as sufficiently complex, fluid

[2] There are perennial debates about the meaning and significance of 'tax avoidance' and 'tax evasion'. Generally, tax avoidance is considered to be lawful and tax evasion is used to describe practices that contravene the law. However, in practice the distinction is often blurred. Often, some strategies have been argued to be 'avoidance', but when challenged and scrutinized in courts they have been found to be 'evasion'. On occasions, companies have structured transactions which have little/no economic substance, but enable companies to reduce their tax liabilities. On moral and ethical grounds, some have objected to such practices (Christian-Aid, 2008, 2009), especially as the loss of tax revenues has negative effect on the provision of public goods, security, alleviation of poverty and social stability.