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Educational Case

International transfer pricing in multinational enterprises

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ABSTRACT

Current curricula in management accounting stress the role of transfer pricing as a tool for measuring the performance of responsibility centers and their managers. Recently, however, multinational enterprises (MNEs) have felt increasing pressure to comply with transfer pricing tax regulation. As a result, tax risk management considerations play a key role in the transfer pricing decisions of MNEs today. This case seeks to provide you with examples of the core principles of international transfer pricing, as well as to allow you to discuss international transfer pricing in the context of responsibility accounting. Specifically, the case study is a fictional MNE, allowing you to apply the OECD Guidelines in practice to cross-border transfers within an MNE, and to discuss the implications of tax-based transfer pricing for responsibility accounting. As a basis for working on the case study, the Appendix provides an overview of the 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (OECD, 2010), hereafter OECD Guidelines, upon which most transfer pricing regulations worldwide are based. It includes an introduction to the arm's length principle, OECD-accepted transfer pricing methods, and comparability analysis procedures for identifying comparable transactions between independent parties. The case study assumes that you are familiar with responsibility accounting and transfer pricing as discussed by standard management accounting textbooks.

1. Introduction

Transfer pricing is useful for a variety of management accounting and control issues, including the performance measurement of responsibility centers and their managers. Management accountants and controllers have traditionally been involved in determining suitable transfer prices for such non-tax purposes. However, for intra-group cross-border transactions in multinational enterprises (MNEs), tax compliance has become a dominant concern attracting more attention from MNE management than the traditional management accounting objectives of transfer pricing.[1] MNEs' emphasis on tax compliance stems from an increase in the scope and complexity of transfer pricing tax regulations. Generally, international transfer pricing is subject to increased attention from MNE stakeholders, including policy makers, tax authorities and trade institutions such as the Organisation for Economic Co-operation and Development (OECD). This includes OECD's comprehensive action plan (OECD, 2013) set out as part of its project on base erosion and profit shifting (BEPS). The BEPS project seeks to prevent alleged tax avoidance in MNEs through various tax schemes including international transfer pricing as well as to reduce inefficiencies in

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[1] According to the Ernst & Young 2013 survey (Ernst & Young, 2013, p. 15), the highest priorities in transfer pricing strategies are 'Tax risk management' (66%), 'Effective Tax Rate optimization' (11%) and 'Alignment with management/operational objectives' (14%).

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international tax rules and arbitration mechanisms. Some of the BEPS reports (OECD, 2015) relate to the introduction of simplified transfer pricing mechanisms for administrative services as well as an introduction to valuation techniques for intangibles used in intra-group transactions. In addition, a new comprehensive documentation package is put forward, requiring additional information on value creation throughout the MNE value chain as well as a country-by-country report on specific measures of economic activity. Hence, international transfer pricing continues to be on top of the international tax agenda.

Most MNEs choose to apply a single set of transfer prices for both tax reporting and internal managerial purposes. However, even when MNEs decide to decouple their transfer prices, i.e., to use different transfer prices for managerial purposes and for tax reporting, such a managerial transfer price is usually not independent from the tax-based transfer price and the different corporate income tax rates that characterize the various international locations (Hiemann & Reichelstein, 2012). Hence, understanding the basics of tax-based transfer pricing is relevant regardless of whether one or two sets of books is applied.

Although current management accounting textbooks mention the increased importance of the tax perspective of international transfer pricing, they provide few operational instructions as to how MNEs can determine tax-compliant transfer prices and how such transfer prices interact with objectives and concepts in the responsibility accounting domain.[2] In this context, we find it highly relevant that management accounting students preparing for professional careers in globalized organizations acquire competencies with respect to international transfer pricing. In addition, management accounting students need to understand how international transfer pricing regulations interact with responsibility accounting. Therefore, we also include a task on responsibility accounting and performance measurement because this issue in practice is perceived to be the most critical non-tax issue of transfer pricing.[3]

2. OECD guidelines

The OECD Guidelines are based on the arm's length principle, which states that MNEs in their intra-group trade must act as if they are independent companies operating on market terms. The Guidelines provide MNEs and tax authorities with an operational manual for applying the arm's length principle, requiring MNE group companies to use transfer prices that are in accordance with the prices *that independent parties would have applied in comparable circumstances*. Hence, the arm's length principle works on the basis of *comparability* between intra-group transactions and comparable market transactions. The Appendix provides an overview of the 'OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations' (OECD, 2010), hereafter OECD Guidelines, upon which most transfer pricing regulations worldwide are based. This includes an introduction to the arm's length principle, OECD-accepted transfer pricing methods, and comparability analysis procedures for identifying comparable transactions between independent parties.

3. Case study

3.1. Case information

UH Group is an MNE active in the business of manufacturing and distributing smartphones. The group's new Chief Financial Officer (CFO), Gregg Clapper, was recently headhunted by UH Group from a similar position at another company. He has worked for a long time in the tech industry and has the reputation of being knowledgeable in management accounting. At a recent CFO network meeting, Gregg Clapper learned that a well-known MNE had incurred some major adjustments to its international transfer prices because the tax authorities had found them to be not in accordance with regulatory requirements. Someone at the meeting had mentioned something about 'OECD Guidelines' and talked about the importance of performing a 'comparability analysis' to determine 'arm's length transfer prices', but Mr. Clapper was not familiar with these concepts. On the train back to headquarters in Dublin, Ireland, he wondered what he could do to ensure UH Group's international transfer prices would be set at arm's length. Additionally, he wondered how the OECD Guidelines would potentially impact UH Group's subsidiaries, particularly in terms of what type of responsibility center he should classify each subsidiary as and what performance measures would be suitable to apply to each of them. Upon arrival at the headquarters, Mr. Clapper decided to hire an accounting firm with expertise in international transfer pricing. You work for this accounting firm, and your manager involves you in this case. To start, this manager asks you to retrieve some basic structural facts about UH Group. You contact Gregg Clapper, who provides you with the following information a few days later:

P is the parent company of UH Group and is based in Ireland. P owns two companies: a manufacturing company M, located in Germany, and a distributor D, located in France. M manufactures a smartphone called Aloha, which has unique product features that differentiate it from otherwise similar smartphones in the market. For example, it includes new and

[2] The research on the tax versus management control uses of international transfer pricing has produced both analytical studies (e.g. Baldenius, Melumad, & Reichelstein, 2004; Hiemann & Reichelstein, 2012) and case studies (Cools, Emmanuel, & Jorissen, 2008; Cools & Slagmulder, 2009; Plesner Rossing, 2013). These studies confirm the need for management accounting students to get more familiar with international transfer pricing from a tax perspective, based on the globally recognized OECD Guidelines.

[3] We recognize that transfer pricing has many non-tax objectives: our experience from working intensively with transfer pricing in MNEs over the past ten years is that the performance measurement of responsibility center managers is the main issue sought to be balanced with the tax compliance objective. Hence, this paper focuses on these two central issues.