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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 amongst 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.

Keywords: Transfer pricing, Tax avoidance, Globalization, Flight of capital, Conflict.

THE DARK SIDE OF TRANSFER PRICING: ITS ROLE IN TAX AVOIDANCE AND WEALTH RETENTIVENESS

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).

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, Jensen and Schott, 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 at 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 1,724 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 £1,134 million (Hansard, UK House of Commons Debates, 10 November 2008, col. 938) and a further £2,114 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 five 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 and still weakly regulated terrain where detection is low and transgression is calculated as an acceptable business risk.[3]

Transfer pricing is a well-established topic in accounting textbooks, but the use of transfer pricing[4] to avoid taxes and shift capital has attracted little sustained interest (Sikka et al., 2007). The bourgeoning corporate social responsibility literature is largely silent on the role of transfer pricing in tax avoidance and the flight of capital (Christensen and Murphy, 2004). A considerable body of literature draws attention to the economic theories underlying transfer pricing (e.g. Hirshleifer, 1956; Abdel-Khalik and Lusk, 1974; Plasschaert, 1994), organizational processes (for example, Cools, Emmanuel and Jorissen, 2008) and income shifting tendencies (for example, Harris, 1993; Klassen, Lang and Wolfson, 1993; Jacob, 1996; Oyelere and Emmanuel, 1998; Emmanuel, 1999; Smith 2002), but comparatively little attention is paid to what might be termed the 'politics' of transfer pricing. There are few illustrations of the pricing strategies used by companies.

This paper seeks to draw attention to the dark side of transfer pricing by examining its role in relation to struggles over the distribution of economic surplus. Its purpose is not to advance an alternative theory of transfer pricing, or offer interpretation of complex legislation and the case law relating to it, or even to develop some new conceptual categories for its analysis. Its more modest ambition is to intensify attention to a key area of accounting practice and policy that is largely invisible to students of accounting and of seemingly low priority to the media, politicians, regulators and corporate critics. It relies upon publicly available information to provide illustrations of transfer pricing practices. The paper is organised in three further sections. The next section locates transfer pricing decisions within the dynamics of capitalism to develop a framework for understanding its role in conflicts over resource allocation. The second section presents some evidence to show that transfer pricing practices are implicated in tax avoidance and the flight of capital, both in developing and developed economies. A third and final section summarises the paper and attends to the broader social relevance of transfer pricing policies.

A Perspective on Transfer Pricing

Corporations dominate the contemporary economic, political and social landscape of most nations (Korten, 2001; Monbiot, 2000; Klein, 2001). In accordance with the logic of capitalism, the legal obligation of corporations is primarily to increase profits and dividends for the benefit of their shareholders. Such priorities are enshrined in law. For example, Section 172 of the UK Companies Act 2006 requires directors to promote the success of the company for the good of the shareholders as a whole, and in that process have regard for the interests of other stakeholders (e.g. the environment, customers, suppliers, employees and community), i.e. the interest of other stakeholders are subordinated to the pursuit of shareholder wealth maximisation. To this end, companies sharpen their competitive advantage by developing new products, services and niches and also squeeze a variety of stakeholders to deliver and increase shareholder value (Kennedy, 2000). Extensive use of financial engineering has been embraced to improve corporate earnings. As Froud et al. (2000) put it, "even in blue-chip companies, whose management once built factories and market share, operating management becomes an endless series of cheap financial dodges: this year's target is met by ending the defined benefit pension scheme, which saves labour costs, and next year's dodge is leasing the trucks so that capital appears in someone else's balance sheet. This work is punctuated by and interrupted by major restructurings and changes to ownership where it is financial engineering which is crucial..." (p. 109). In this context, taxation is targeted by financial engineers who regard it as an avoidable cost, rather than a return to society on the investment of social capital (education, security, healthcare, legal system, etc.) and a contribution to society for investment in social infrastructure.

Accounting firms are on hand to assist in the development and legitimation of tax avoidance measures (KPMG, 2004, 2009a, 2009b; Deloitte and Touche, 2007). Rather than portraying tax as a contribution to social development and a return on investment made by society to facilitate business activity, an Ernst & Young argued that "Tax is a cost of doing business so, naturally, a good manager will try to manage this cost and the risks associated with it" (Irish Times, 7 May 2004) and "Companies are constantly looking to save costs, and tax is a major cost" (New York Times[5], 7 April 2009). Specifically, Deloitte & Touche advise that by "engaging in transfer pricing planning from day one rather than waiting until the tax holiday ends, the … company and its multinational group may be able to take advantage of the tax holiday to shift a supportable level of profit to … reduce the multinational group's worldwide tax cost" (Deloitte & Touche, 2007, p. 14). Reducing or eliminating taxes is attractive to corporations as it boosts shareholder value, post-tax earnings and returns to shareholders. It also increases company dividends and executive rewards as these are linked to reported earnings. Since the amount of tax payable is dependent on ‘costs’ and ‘income’, corporate attention becomes more intently focused on ‘transfer pricing’ strategies. As a consequence of their implications for taxation, transfer prices are significant not only for the evaluation of performance of corporate divisions, subunits, departments and subsidiaries, but also for the taxes that domestic and foreign governments might be able to levy on corporate profits to finance public goods and social investment.

Often the seeds of some of the transfer pricing games are sown by the contradictory policies of the neoliberal state. For ideological reasons the state has been largely excluded from direct involvement in capitalist production and plays a minor role in directing investment of private capital. At the same time, political processes have encouraged the belief that the state can meet popular demands, provide social welfare, make investments in social infrastructures and deliver public goods (Offe, 1984). The necessary revenues are derived from taxation based on wages, savings, profits and consumption, which in turn depend on the activities of the private sector. Since the liberal state’s revenues and its survival depends upon the long-run development of the private sector (Offe, 1984), its policies are devised to stimulate and sustain economic growth through the expansion of capital by using a variety of contradictory measures, including subsidies, tax shelters, tax incentives and sweeteners such as export subsidies, loans, guarantees and insurances. As rational economic actors corporations exploit these opportunities to maximize their after-tax global income (Emmanuel, 1999). Tax incentives and subsidies are often dependent upon calculations of costs and revenues, but such concepts are highly malleable and are open to competing interpretations (Buchanan and Thirlby, 1973; Berry et al., 1985). Costs, for example, consist of a variety of components, including overhead allocations, which are arbitrary and “incorrigible” (Thomas, 1969, 1974). A company producing, say, furniture and movies - has incentives to devise and charge suitable transfer prices to its movies division, where this enjoys tax concessions so that it can take advantage of tax laws and secure maximum benefit for increasing its reported profits.

In response to the threat to taxation revenues posed by transfer pricing practices nation-states have entered into a variety of bilateral and multilateral agreements to improve regulations (Picciotto, 1992a, 1992b; European Commission, 2004; OECD, 2001, 2009). Such agreements adopt variants of an 'arm's length[6]' approach as they seek simultaneously to support international trade and constrain competing interpretations of 'transfer pricing' (OECD, 1979, 2001). One difficulty with such arrangements is that, in the absence of an active market a suitable transfer price may not be easily ascertainable[7]. This is especially so where companies use trade marks, patents, brands, logos and a variety of company-specific intangible assets[8]. The tax authorities can adjust the transfer prices used by companies, but only if they tax corporate profits and have the necessary administrative and enforcement resources. States may use their lawmaking powers to curb arbitrary calculations, but law[9] itself is, of course, the outcome of politics: through (lawful) lobbying and patronage of political institutions, and corporations may successfully impede or dilute unwelcome legislation and discourage or circumvent its effective enforcement.

Globalization has added new complexities to the politics of transfer pricing. Freed from the limitations of territorial jurisdictions, corporations can more easily establish subsidiaries[10], affiliates, joint ventures, special purpose entities and trusts in favourable geographical locations to take advantage of low taxes and subsidies. An automobile manufacturer can design car parts in countries A and B, have them manufactured in countries C and D, assembled in E and F, hold trade marks and patents in G and H and assign global marketing rights to countries J and K. The emergence of global production creates new and extensive opportunities for transfer pricing strategies by enabling companies to shift profits to more desirable locations and thereby avoid taxes[11]. The sheer scale, power and complexity of globalization poses challenges to conventional thinking on transfer pricing as, in the wake of its complex networks of production and exchange, domestic companies have become multinational and transnational and foreign companies have either set up businesses in new jurisdictions or operate joint ventures with local companies. At the beginning of the millennium 51 of the largest 100 economies in the world are companies rather than nation-states and exercise vast power as indicated by the following snippets (Tripathi, 2000; Korten, 2001; United Nations Food & Agriculture Organisation, 2003; Anderson et al., 2005). The 100 largest corporations controlled assets of $3,400 billion, of which 40% were located outside their home countries. The 200 top corporations accounted for 28% of the world economic activity. The top 500 transnational corporations controlled 70% of the worldwide trade, 80% of the foreign investments, 30% of the global GDP, one-third of all manufacturing exports, 75% of all commodities trade and 80% of the trade in management and technical services; just 20 controlled the coffee trade, 6 of them held 70% of wheat trade and just one controlled 98% of the production of packed tea; 80% of the entire production of world grain was distributed by just two companies (Cargill and Archer Daniel Midland); 97% of all patents are held by nationals of OECD countries almost 90% of these are held by global corporations (Tripathi, 2000; Korten, 2001; United Nations Food & Agriculture Organisation, 2003; Anderson et al., 2005). For 2001, the US related party trade accounted for US$526 billion (46%) of the $1.133 trillion in US imports and $223 billion (33%) of the $731 billion exports (US Treasury, 2003, p.1-2).

The vast increase in global trade and corporate power provides plenty of opportunities for crafting transfer pricing strategies for avoiding taxes, especially as many corporations wield more resources than many nation-states. The US tax authorities state that “two types of activities among related parties—cost-sharing arrangements and services transactions—were key sources of transfer-pricing abuse” (US Government Accountability Office, 2008, pp. 31-32). Often due to thin markets and monopolies, ‘arm’s length price’, the keystone of transfer pricing, cannot easily be substantiated and tax authorities in many developed countries have been inclined to scrutinise corporate policies more closely. Developing countries are highly vulnerable to the use of transfer pricing for tax avoidance and flight of illicit flight of capital (Borkowski, 1997), but their ability to check aggressive practices is often handicapped by the lack of financial resources and consequently the possibilities of hiring expert labour to scrutinise corporate practices more closely (Plasschaert, 1985; Christian-Aid, 2008).

Against the background of considerable corporate discretion, the International Monetary Fund (IMF) states that globalisation of trade creates “problems for national tax authorities deriving from the potential use and abuse of "transfer prices" by the multinationals, including on loans, the allocation of fixed costs, and the valuation of trademarks and patents. Many tax administrators believe that some of these enterprises manipulate these prices to move profits from jurisdictions with high tax to those with low rates” (Tanzi, 2000, p. 10). Evidence suggests that “intrafirm trade prices appear to be influenced by the tax-minimization strategies of multinational firms" (Clausing, 2003, p. 2222) and that there is a tendency for corporations to boost post-tax earnings by reporting "higher taxable profits in countries where taxes are lower" (The Economist, 29 January 2004). The finance director of BMW has publicly stated that "his corporation tried to shift costs to where taxes are highest" (cited in Weichenrieder, 1996, p. 38).

The power of corporations is also strengthened in that under the ideologies of capitalism, nation-states compete to attract investment funds to stimulate domestic economies. Such competition creates opportunities for corporations to devise transfer pricing policies to take advantage of tax differentials and effectively play-off one nation-state against another. More-over, the possibilities of transfer pricing are increasingly shaped by the emergence of microstates, commonly known as offshore financial centres or tax havens, that have been described as "the cornerstone of the process of globalization" (Palan et al., 1996, p. 180). The microstates[12] have used their sovereign legislative powers to preserve secrecy, provide light regulation and impose low/no tax which attract companies seeking to set-up skeletal administrative structures (Sikka, 2003). The secrecy provides spaces to park transactions in shell corporations and engage in creative transfer pricing schemes that bear little resemblance to any arm's length price (Brittain-Catlin, 2005; Bhat, 2009). These offshore structures permit companies to book and route their transactions so as to avoid taxes in many countries (Mitchell et al., 2002; also see United Nations Economic and Social Council, 2001). Remarkably, almost half of all world trade appears to pass through offshore financial centres, even though these jurisdictions account for only about 3% of global GDP (Christensen et al., 2005, p. 67). Microstates account for 1.2% of world population, but 26% of the assets and 31% of the net profits of American multinational corporations are located in these tax havens (Hines and Rice, 1994). Some 3,600 major US corporations are known to be sheltering in the US Virgin Islands and Barbados alone (Rugman, 2000, pp. 22-23). It is estimated that some US$11.5 trillion of assets reside in offshore havens (The Observer, 27 March 2005). Each year some 200,000 new companies[13] are formed in microstate havens and the cumulative numbers could be more than three million (Baker, 2005). The British Virgin Islands has 3,389 companies per 100 head of population and Caymans has 182 companies per 100 people (Meinzer, 2009). The 575 residents of the island of Sark, part of the Channel Islands, hold some 15,000 company directorships, mostly non-resident companies (UK Home Office, 1998). One building in Caymans is the registered address of 18,857 corporations, including some of the largest global companies (US Government Accountability Office, 2008). Microstates, like the Cayman Islands, do not levy taxes on corporate profits and therefore local tax authorities have little reason to be concerned with transfer pricing practices.

Transfer Pricing and Tax Avoidance: Some Evidence

This section provides some evidence of the use of transfer pricing in both emerging and developed economies.

Emerging and Transitional Economies

China is widely regarded as an emerging economic superpower. Its recent export-led economic growth of over 10% per annum has been fuelled by foreign direct investment (FDI) interacting with cheap labour and indigenous technology to produce an export-led boom. The Chinese government continues to develop sophisticated property rights, land and foreign investment protection laws (e.g. relating to bankruptcy[14], patents, trade marks) and has sought to attract FDI by offering a variety of tax incentives and concessions to foreign corporations (Chan and Chow, 1997; Moser, 1999; Sun 1999; Ho and Lau, 2002). Incentives and concessions have included a two-year tax holiday starting with the first profit-making year and a 50% tax reduction for the following three years. Foreign corporations investing in high technology industries and low profit industries, such as agriculture and forestry, have qualified for tax holidays for two further years. Foreign corporations investing in special economic zones have benefited from considerably lower tax rates (15% compared to the normal rate of 33%). Some provinces and cities have also offered a variety of tax inducements and subsidies (e.g. lower land using fees). To support its domestic economy, the government has restricted foreign companies' access to some domestic markets, retained some foreign exchange controls and levied a withholding tax on profit repatriation. In addition, China's currency is not fully floated on the foreign exchanges and its value is primarily fixed by the government rather than the markets.

The Chinese economic boom and tax incentives have created profitable business opportunities. In 1980, FDI was only US$57 million but reached US$35.8 billion in 1995 (UNCTAD, 2003). By the late 1990s, some 140,000 foreign investment enterprises were operating in China. At this time around 54%, 63% and 70% of the foreign investment enterprises reported operating losses of US$7.1 billion to the tax authorities for the years 1993, 1994 and 1995, respectively (Ho and Lau, 2002). The reported losses should have prompted multinational corporations to contemplate withdrawal from China. Yet, by the year 2000 inward FDI reached US$40.7 billion, rising to a record US$92.4 billion in 2008[15]. By 2004 the number of foreign investment enterprises operating in China rose to 490,000. However for the period 1996 to 2000, between 60% and 65% of the companies with foreign investment reported negative taxable profits and paid no taxes (Baker, 2005, p. 145). By 2005, some 55% of the foreign invested enterprises were claiming to be making losses (Global Times[16], 31 July 2009). The Chinese government's official website stated that "Tax evasion through transfer pricing accounts for 60 percent of total tax evasion by multinational companies[17]". A 2007 survey by the National Bureau of Statistics claimed that almost two thirds of apparently loss-making foreign enterprises had deliberately made false reports and used transfer pricing to avoid paying 30 billion yuan (US$4.39 billion) in taxation (Global Times, 31 July 2009). China has beefed up its anti-avoidance and transfer pricing regulation (Mo, 2003; KPMG, 2009a) and has also become more aggressive in its transfer pricing investigations. The tax authorities reported that before 2005 they investigated around 1,500 cases of transfer pricing annually, but after introducing aggressive audits the figure has fallen to about 300 cases and yielded additional tax revenue of around 460 million yuan. The aggressive approach in 2007 resulted in 192 cases but revenues of 987 million yuans (Shanghai Daily[18], 4 February 2008).

Several studies have identified the creative use of transfer prices, especially the adjustment of import and export prices that shifts profits from China to more desirable locations. In a study of the automotive industry, Wang (2001) concluded that by "quoting a higher-than-market price on equipment …….. parts and raw materials, foreign firms may be able to by-pass the various regulations on the repatriation of profits, and finally may understate the level of domestic earnings" (p.6). Moreover, since joint ventures rely on purchase of components and technologies from parent companies, "foreign investors intend to prolong the purchase period to maximise the profits generated from transfer pricing" (Wang, 2001, p. 11). One study estimates that Chinese exports by multinational corporations are underpriced by an average of 17% whilst imports are overpriced by an average of 9% (Sun, 1999). The Chinese tax authorities claim that tax evasion by multinational companies is costing them more than 30 billion Yuan (US$3.6 billion) in lost tax revenues annually and that " ... almost 90 per cent of the foreign enterprises are making money under the table. … most commonly, they use transfer pricing to dodge tax payments …" (China Daily[19], 25 November 2004). Despite strict currency controls, China is estimated to be deprived of around US$100 billion of capital each year, primarily through mispricing of imports and exports (Gunter, 2004).

Russia, another emerging economy, also provides evidence of the impact of transfer pricing practices. Following the collapse of communism, the Russian economy suffered considerable decline. There was a reduction in GDP of -14%, -8.7%, -12.7%, -4.2% and -3.6% respectively for the years 1992, 1993, 1994, 1995 and 1996, representing a drop of around 42% in the country's output (Bush, 2003). Compared to China, the level of FDI has, until recently, been comparatively low. The cumulative FDI for the years 1991 to 2003 was only US$19.6 billion compared to US$350 billion for China for the same period. Out of a global total of US$1270 billion in 2000, Russia received FDI of only $4.4 billion. In the absence of substantial FDI, the Russian government sought to revive the economy through market liberalisation, decentralisation of economic planning, currency devaluation, privatisation of state owned assets, and joint ventures with foreign owned multinational corporations (Vasilyev, 2000). Russia's 89 regions were given considerable autonomy to offer tax incentives and subsidies (for an indication see Weinthal and Luong, 2001). A series of low/no tax zones were also created.

Transfer pricing rules and the "arm's length" model were first introduced in Russia in 1999 (St. Petersburg Times[20], 20 March 2007). Some of the issues have been given visibility by the trade in oil and gas which are major contributors to the Russian economy[21] (Ahrend, 2004). In early 2004, a World Bank report stated that the country's oil and gas exports accounted for 25% of the country's GDP rather than 9% reported in the official data (Financial Times, 19 February 2004). The major reason for the discrepancy was that corporations exploited a variety of "tax loopholes, engaged in transfer pricing — including creating a series of on and off-shore trading companies to purchase oil at low cost from production sites and then sell it back again through intermediaries" (The Globalist, 1 December 2004). World Bank officials state that "many large Russian firms benefit from transfer pricing by employing trading companies to avoid taxation. Companies sell their products to trading subsidiaries at below-market prices; these trading subsidiaries then sell the product to the end customer at market prices and pocket the difference ….. typically shell companies are registered in remote regions …. [some] simply disappear soon after they have concluded as many transactions with end customer as possible". (Ruehl and Schaffer, 2004). For example, Russian oil priced for sale internally at US$10 a metric ton was sold to an exporter's foreign subsidiary at $10 a metric ton and then resold to foreign buyers at the market price of US$120 a metric ton, with the profits being booked and retained at external companies (Baker, 2005, p. 152). A report by the Russia's Audit Chamber noted that 80% of the coal exported from Russia is sold through offshore entities. The trading companies registered offshore accumulate significant coal revenues as Russian producers sell to them at a discount of 30-54% to global prices (Bloomberg, 11 July 2009). As a result companies avoid taxes because profits are not booked in Russia.

Russian gas company Gazprom created Itera, an affiliated company based in Jacksonville, USA. It has been claimed that gas with a Russian domestic price of $2 to $4 per thousand cubic meters has been sold at that price to the US which Itera then resold to Russian republics at between US$30 to US$90 per thousand cubic meters, with the profits being retained in the US (Baker, 2005, p. 156; Browder, 2002). Another study estimated that between 1995 and 1999, exports of just twenty-five items from Russia to the US may have been under-invoiced by US$7.24 billion whilst imports may have been over-priced by US$1.68 billion, resulting in a possible capital flight of US$8.92 billion (de Boyrie et al., 2005). Taxed at 25%, this would have yielded considerable revenues for investment in social infrastructure. Whilst the full extent of the flight of capital from Russia is open to conjecture, Goskomstat (now known as Federal Statistics Service) estimated that between 1990 and 1995 up to US$400 billion of capital may have been taken out of Russia to the US, UK, Cyprus, Switzerland, the Netherlands and Denmark (Tikhomirov, 1997).

Lost tax revenues and the accompanying flight of capital was the legal basis for the prosecution of Russia's biggest privatised energy company, Yukos (owned by Group Menatep, registered at a Gibraltar post office box), whose annual audited accounts complied with the US GAAP. Yukos founder and former chief executive Mikhael Khodorkovsky was alleged to be "doing an enormous amount of asset stripping and transfer pricing" (The Observer, 26 March 2006). In a 120 page document, the Russian government set out its case against Yukos and a number of shell companies in Russia, as well as Switzerland, Gibraltar, Panama, and the Isle of Man with respect to its transfer pricing schemes (Komisar, 2005; Clateman, 2005a, 2005b, 2006; Tanega and Gololobov (2007). Allegedly, these schemes enabled Yukos and its affiliates to reduce its revenue for the year 2000 by RUR210 billion and the government sued the company for US$28 billion for back taxes and penalties. The Russian government claimed that a Yukos production subsidiary sold crude oil at below-market prices to a shell company (i.e., a company with virtually no assets, employees or operations of its own) allegedly affiliated with Yukos and established in a low/no tax region. The shell company resold the oil to domestic and foreign buyers at market prices. Yukos controlled the entire operations and finances of the shell company via placement of directors, powers of attorney and also an agreement with the shell company under which Yukos organized the purchase, sale, transport, processing and shipment of oil. Most of the shell company's transactions were with other Yukos affiliates. Yukos received nominal commission for these services (0.01--0.5%); and the shell companies received the bulk of the profit resulting from the entire chain of production and sale of the oil. The transfer pricing policies enabled Yukos to avoid taxes as the shell companies enjoyed concessions on profits tax in addition to a host of revenue taxes (such as road use tax, housing stock and social benefits tax and property tax).

Transfer pricing practices continue to pose challenges to developing countries keen to attract investment from multinational corporations (UNCTAD, 1999a, 199b), and may be responsible for a capital flight[22] of around $365 billion a year from the poorest nations to the richest (Christian-Aid, 2009). According to a former member of the UN North-South Commission, “the pharmaceutical TNCs make internal sales to their Latin American subsidiaries at prices between 33% and 314% above world market levels. Other examples are: rubber industry, 40%; chemicals, 26%; electronics, 1,100%” (cited in Tandon, 2000). Cuddington (1986) has estimated that for the years 1977 to 1983, exports to richer nations from Argentina, Brazil, Chile, Mexico and Uruguay were undepriced by an average of 19.6%, 12.7%, 12.8%, 33.6% and 27.8%, respectively. Zdanowicz et al., (1999) estimate that during 1995, imports and export prices from US to Brazil were mispriced by 15.23% and 11.3% resulting in capital flight from Brazil to US of between $2 billion and $4 billion.

India has become a hub for the service industry. Many IT, pharmaceutical and financial services multinational companies have located research and labour-intensive operations in India to take advantage of cheaper labour and local technology. Such activities are controlled from external locations and multinationals provide global advice and infrastructure in return for service agreements and royalty charges. After scrutinising the transfer pricing practices of over 1,000 companies, the Indian tax authorities have demanded additional taxes from 250 companies, including Bank of America, Citibank, Coke, Standard Chartered Bank, American Express Bank, Hero Honda, Johnson & Johnson, H Lever, Microsoft, Samsung and Sony (India Times, 22 June 2005).

Due to transfer pricing practices of multinational companies, Papua New Guinea is estimated to have lost tax revenues of between $9 million and $$17 million, in 1999, on its forestry business alone, which far exceeds the country’s education and healthcare budgets (Hunt, 2002). More recent estimates suggest that it may be losing $100 million of tax revenues a year because of the transfer pricing policies of international timber companies (Forest Trends, 2006). A key strategy is that the “logging companies are grossly understating the value of timber exported ….. timber exports are laundered through the overseas subsidiaries of companies exporting the timber. Importers buy the timber from the subsidiaries at much higher prices than those declared to the PNG [Papua New Guinea] tax office at the point of export” (The Australian, 20 July 2006). More widely, transfer pricing has been used by multinational logging companies to avoid payment of taxes that could otherwise provide citizens in developing countries with revenues vital for their economic development (Dauvergne, 1998).

Developed and Advanced Economies

Transfer pricing issues also pose challenges to more developed economies. By examining the US customs data and filings of import and export prices used by corporations, Pak and Zdanowicz (2002) provide some instructive examples. Plastic buckets from the Czech Republic have been priced at $972.98 each, fence posts from Canada at $1,853.50 each, a kilo of toilet paper from China for $4,121.81, a litre of apple juice from Israel for $2,052, a ballpoint pen from Trinidad for $8,500, and a pair of tweezers from Japan at $4,896 each. Examples of export prices include a toilet (with bowl and tank) to Hong Kong for $1.75, prefabricated buildings to Trinidad at $1.20 each, bulldozers to Venezuela at $387.83 each, and missile and rocket launchers to Israel for just $52.03 each. For the year 2001 alone, such practices may have deprived the US government of US$53.1 billion of tax revenues (Pak and Zdanowicz, 2002).

The above are doubtless extreme, eye-catching examples but they are suggestive of a widespread, systematic setting of transfer prices in whatever direction helps to avoid taxes and boost profits. The prevalence of such schemes and practices is extremely difficult to assess as their use tends to come to light only through unexpected corporate collapse, whistleblowers, investigative journalists, regulatory interventions or court actions. According to well placed economists "Businesses--and especially the financial sector--establish dummy companies and adjust their transfer pricing (*e.g.* on sales of raw materials to refineries, and of refined or semi-manufactured products to their final distributors in the industrial nations) so as to take all their profits in these tax-free [tax havens] enclaves" [and] "oil majors were able to "game" the world's tax systems by selling their crude oil at so low a price to their tanker companies as to leave little income for Saudi Arabia, Venezuela or other oil producing countries" (cited in Schaefer, 2004). A similar picture is presented by a former Senior Fellow of the Brookings Institution: "I have never known a multinational, multibillion-dollar, multiproduct corporation that did not use fictitious transfer pricing in some part of its business to shift money between some of its entities. In years past, chemical companies were a common example of falsified transfer pricing, taking advantage of proprietary products to move revenues and relocate profits. The pharmaceutical companies widely known for the same practice were invoicing as much as 10 times or more for the same product sold to one subsidiary out of which profits were drawn as compared to another subsidiary where profits were permitted to remain" (Baker, 2005, p. 170). In evidence to the US Senate Finance Committee, the Commissioner of the US Inland Revenue Service (IRS) stated that "taxpayers shift significant profits offshore by manipulating the price of related-party transactions so that the income of an economic group is earned in low-tax or no-tax jurisdictions, rather than the U.S., thus reducing the enterprise's worldwide income tax liability. … The levels of aggressiveness vary from one taxpayer to another. … high technology and pharmaceutical industries, are shifting profits offshore through a variety of arrangements that result in the transfer of valuable intangibles to related foreign entities for inadequate consideration. Cost sharing arrangements are often the method of choice for this activity. The buy-in amount in cost sharing arrangements is particularly troublesome. It is often understated, resulting in the improper shifting of income offshore. … The Transfer of Intangibles and Transfer Pricing issues present significant compliance challenges in the multinational corporate/enterprise tax administration arena. … The level of the non-compliance is likely to increase ... " (Eversen, 2006).

These observations from people well placed to assess the widespread use/abuse of transfer pricing indicate how companies have developed a variety of strategies to shift income to low/no tax jurisdictions. The unravelling of the Enron affair has shown how, with advice from Arthur Andersen, Deloitte & Touche, Chase Manhattan, Deutsche Bank, Bankers Trust and major law firms, the US energy giant created 3,500 domestic and foreign subsidiaries and affiliates, including in places such as Turks and Caicos, Bermuda and Mauritius. A US Senate inquiry into Enron's tax avoidance strategies noted that by designing appropriate transfer pricing policies that shifted income to tax havens. The Senate report stated that "One aspect of Enron's business, however, did raise persistent and significant transfer pricing issues. These issues involved the treatment of services performed by Enron for the benefit of related foreign entities in connection with the foreign infrastructure development business. ……. At a very early stage in the project development process, the project typically was handed off to a local project entity that was owned by Enron (often jointly with a third-party co-venturer), with Enron' interest in the project entity typically held in two or more Cayman Island holding companies" (US Senate Joint Committee on Taxation, 2003, p. 383). Such corporate structures enabled Enron to levy and book fees in tax havens. The same fees were tax-deductible expenses in other locations. Enron's profits of US$1.785 billion for the years 1996 to 2000 attracted no taxes. It also avoided taxes in developing countries such as India and Hungary.

The winding up of another multinational, WorldCom, a US-based company, revealed how it had made creative use of transfer pricing for a variety of trademarks, trade names, trade secrets, brands, service marks and intellectual property. For a fee of US$9.2 million, accountancy firm KPMG advised the company to increase its post-tax earnings by adopting an intangible asset transfer pricing program. Under this, the company created the asset "management foresight[23]", a previously unknown type of intangible asset (United States Bankruptcy Court Southern District of New York, 2004). The parent company registered this in a low tax jurisdiction and licensed it to its subsidiaries in exchange for annual royalty payments, an arrangement which anticipated tax savings of US$25 million in the first year and US$170 million over five years (United States Bankruptcy Court Southern District of New York, 2004, p. 27). WorldCom's insolvency examiner found that in some cases the royalties charged actually exceeded the company's consolidated net income in each of the years 1998-2001, and in other cases represented 80 to 90 percent of a subsidiary's net income. Over a four year period covering 1998-2001, more than US$20 billion was accrued in royalty fees for use of the company's intangible assets and most of the fees resulted from the licensing of "management foresight". The paying subsidiaries treated royalty charges as an expense that qualified for tax relief whilst the income in the hands of the receiving company attracted tax at a low rate. This transfer pricing arrangement may have saved the company between US$100 million and US$350 million in taxes.

The 2005 US court decision relating to Xilinx offers an interesting insight into the allocation of costs to global operations. In accordance with a cost-sharing agreement the US- based company allocated part of its research and development costs to its subsidiary in Ireland, a place which levied a lower tax rate on profits. The Irish subsidiary had six research and development employees, who were eligible to receive shares in Xilinx as part of the remuneration package. When those employees exercised options or bought parent shares under the company's discount purchase plan, the Irish subsidiary compensated the parent for the difference between the exercise price and the fair market value of the shares, according to a 1996 agreement between the two. However, for tax purposes none of the costs were allocated to the Irish company because the cost-s haring agreement did not specifically address the issues. The tax authorities argued that the share option expenses were implicitly part of the cost sharing agreement, but the company claimed otherwise and cited normal industry practices to support its claims (see United States Tax Court, 2005 for background to the dispute). In 2009, the U.S. Court of Appeals decided[24] that the cost of share options also had to be shared (Wall Street Journal, 29 May, 2009).

The transfer pricing policies of GlaxoSmithKline, a global pharmaceutical company, have also been scrutinised by the US tax authorities who claimed that the rate the company charged for marketing services supplied by its U.S. affiliate from 1989 to 1996 was far too low, and thus understated Glaxo's US income and avoided around $5.2 billion of US taxes (Daily Telegraph, 8 January 2004). After some 17 years of protracted litigation and negotiations, Glaxo settled the dispute by making a payment of US$3.4 billion (US IRS press release[25], 11 September 2006; The Times, 12 September 2006). However, the company is involved in another $1.9 billion dispute (Wall Street Journal, 23 May 2009). The US tax authorities are also said to be scrutinizing the transfer pricing practices of some of the largest corporations, including Home Depot, Limited Brands Inc., Kmart Corp., Gap Inc., Sherwin-Williams Inc., Tyson Foods Inc., Circuit City Stores Inc., Stanley Works, Staples Inc., and Burger King Corp (Wall Street Journal, 9 August 2002, p. A1). They have also sued Shell, Mobil Oil, Oxy USA, Chevron, Conoco, BP Amoco, Texaco, Pennzoil, UPRC, Sun Oil Company, Kerr-McGee, and Exxon for allegedly pricing energy sales at below-market posted prices and have secured a settlement of $400 million[26]. The authorities have also demanded US$1 billion in back taxes plus interests and penalties from Symantec (maker of the Norton brand of antivirus and security software) for transfer pricing practices in connection with technology licensing agreements[27].

The transfer prices of another major pharmaceutical company, SmithKline, came under scrutiny by the Canadian tax authorities (Turner, 1996; McMechan, 2004). For the years 1980 to 1989, the authorities challenged the company's pricing practices for cimetidine, an active ingredient used in the manufacture of the drug Tagamet. SmithKline formulated, packaged and distributed the drug and earned considerable profits in Canada. However, under an agreement made in 1977, the company purchased its key ingredient (which was under patent protection) at $400 per kilogram from its offshore affiliates located in low-tax jurisdictions, the Bahamas and Ireland. In the early 1980s, generic forms of the ingredient became available at prices ranging from $50 to $250 per kilogram and this reduced the market price of the drug. Meanwhile, SmithKline continued to purchase the ingredients under the pre-existing agreement at $400 per kilogram, resulting in the reporting of lower profits and even losses in Canada. The tax authorities argued that the profits in Canada had been artificially deflated by the company's transfer prices which ignored the open market prices. Following protracted litigation, a judge concluded that "If this company . . . had been paying the international market price for supplies of this drug rather than a higher price to a related corporation [at a non-negotiated price], its operating profits then would have been almost three times as much. . . . One could readily speculate that the company would still have been in a profitable position had it decided not to purchase the more expensive drug from its sister subsidiary" (cited in McMechan, 2004). After a further wrangling of eight years, the tax authorities eventually disallowed $51.5 million of deductions and the company also paid the Crown $3.2 million in legal costs.

Tax havens have become a key feature of the transfer pricing strategies of multinational companies. Everyday goods often physically leave for country A from country B, but contracts are routed through tax havens. This is illustrated by the trade in bananas, which are shipped to the UK from the Caribbean but the supplying companies route the transactions through subsidiaries in the Cayman Islands, Bermuda and the British Virgin Islands (The Guardian, 6 November 2007). Based on information provided by whistleblowers, The Guardian reported that the bananas typically sold for £1 in the UK shops begin their journey with a cost of 13 pence in the growing country (10.5 pence production cost + 1.5 pence labour cost + 1 pence profit). Another 47 pence is added via intragroup purchases from wholly owned subsidiaries located on low/no tax jurisdictions before being sold to the UK supermarkets for 61 pence.[28]. The services include 8 pence for the use of a purchasing network located in the Cayman Islands, 8 pence for the provision of financial services from Luxembourg, 4 pence for the use of the brand name registered in Ireland, 4 pence for the provision of insurance by a subsidiary in the Isle of Man, 6 pence for management services from a subsidiary in Jersey and 17 pence for the use of a distribution network provided by a subsidiary registered in Bermuda. Effectively, the company is paying itself for the services added and since the revenues are booked in low/no tax jurisdictions 47 pence of income is virtually tax-free. The Guardian reported that Dole, Chiquita and Fresh Del Monte, which dominate the banana trade, had combined global sales of over $50bn (about £24bn) in the five years to 2006, and made $1.4bn of profits. They paid just $200m (or 14.3% of profits) in taxes between them in that period (The Guardian, 6 November 2007). The newspaper also reported that Fresh Del Monte had 48% of its sales in the US in 2005 but reported a loss of $35.2m. Overseas it made a profit of $133.5m. It paid no tax to the US government.

In April 2008, the Japanese car manufacturer Honda informed[29] the US Securities and Exchange Commission (SEC) that it has set aside $7.7 billion as contingency against a potential tax adjustment relating to an inquiry into its transfer pricing practices by the Tokyo Regional Tax Bureau. The Japanese authorities allege that the total profit made by Honda and its Chinese joint venture companies in China was not an "arms' length" allocation but rather that too much of this total profit was realized by the Chinese joint venture companies over the five-year period ended 31 March 2006. During this period many Chinese companies enjoyed tax holidays and low start-up tax rates. The 2003 annual accounts of Honda relating to its UK operations state that the UK tax authorities are conducting an inquiry into the company's transfer pricing practices (Financial Times, 21 July 2004). The UK authorities are also examining the policies of other manufacturers. Notes to the Nissan Motor (GB) account reveal that the UK authorities are examining the company's transfer pricing practices since 1990 (Financial Times, 21 July 2004). The authorities claim that by virtue of its pricing of imported vehicles and parts, Nissan understated its UK profits by £400 million and added that "Transfer pricing has all the tax authorities worried. When you have a global organisation moving products and components across borders there is the obvious suspicion that they are attempting to avoid tax rather than simply trying to improve efficiency" (Daily Telegraph, 12 November 2004). Similarly, the UK government has questioned the transfer pricing policies and related royalty payments by IBM. The investigation centred on the claim that the UK part of the company had increased its royalty payments from 8% to 12% of its income derived from the sale of products and services to IBM Corp, its loss-making American parent company (The Register, 12 August 1999[30]). IBM is alleged to have paid £700 million to the UK tax authorities to settle the case (The Observer, 22 June 2003).

Multinational corporations have been using transfer pricing to switch their profits to Ireland (Stewart, 1989; The Herald, 16 March 2006). Shifting costs and revenues to Ireland is attractive because corporate profits are taxed at 12.5%, nearly a third of the rate in the US, and the government offers tax incentives and exemptions to research and development companies. In just eight months after registering its business in Ireland in 2005, SanDisk, a major US supplier of MP3 music players and memory cards, recorded a net profit of $105.96 million on revenues of $955 million. The company had no direct local staff but employed the resources of an Irish subsidiary which had an average of eight staff (Irish Times, 23 February 2007). In 2001, Microsoft, established a subsidiary, Round Island One Limited, operating from the offices of a Dublin law firm. By 2004, Round Island controlled US$16 billion of Microsoft's assets and gross profits of nearly US$9 billion, approximately 22% of the company's global profits (Wall Street Journal, 7 November 2005, p. A2). Much of Round Island's income came from royalties and licensing fees for copyrighted software code that originated in the U.S. Through another company, Flat Island Co., Round Island licenses rights to Microsoft software throughout Europe, the Middle East and Africa. Round Island has absorbed other Microsoft units, from Israel to India, moving much of their intellectual property to Ireland[31]. As a result of the licensing and royalty arrangements, Microsoft's world-wide tax rate declined, as the company shaved at least US$500 million off its tax bill (Sunday Times, 12 February 2006). US tax authorities are said to be looking at Microsoft's transfer pricing practices. The same scrutiny is also being applied to a number of other companies, such as Dell, Pfizer, Oracle, Lucent Technologies, Apple and Hewlett-Packard, that have relocated their intellectual property to Ireland (Wall Street Journal, 7 November 2005, p. A2).

There is nothing unusual about multinational corporations purchasing or creating and then holding intellectual property in low-tax jurisdictions and charging other group members royalties for using the same (Pritchard, 2001). The advantage is that subsidiaries and affiliates can claim tax relief on costs whilst the recipient pays little or no tax on the income. Nestlé, a multinational food company, conducts manufacturing operations through 285 plants located in 55 countries. Its market share is built upon the use of trademarks for well-known products, such as Nescafe and Chambourcy. Its trademarks are held by companies registered in Switzerland, a low-tax jurisdiction. Upon acquisition of companies in Australia, it transferred a variety of trademarks to a Swiss company. In return, the Swiss company made royalty charges for the use of trademarks. In the seven years to 2000, Australian companies made payments of A$311 million to the Swiss companies. Since the assets in question are very specific, an independent arm's length price is not easily ascertainable and, on a number of occasions, the Australian tax authorities have contested Nestlé's tax liabilities. (Pritchard, 2001). The US tax authorities have also looked at the transfer pricing policies of Nestlé. Nestlé had established a subsidiary, Westreco, in the US to provide research and development services. The Swiss parent company reimbursed Westreco for all salaries, rent, consulting fees, raw materials, equipment, and administrative expenses, but not taxes, plus a percentage mark-up. The US tax authorities argued that the mark-up was too low and effectively enabled the US subsidiary to shift income and avoid US taxes. In this case, the court (*Westreco, Inc. v. Commissioner, 1992*[32]) sided with Nestlé.

Companies do not necessarily have to transact internationally to develop transfer pricing policies for the use of intellectual property. For example, the federal structure of the US has permitted places such as Delaware and Nevada to offer lower tax rates or special provisions for income from intangible assets. Forsberg (2003) explains that in accordance with well-established legal procedures a parent company transfers its trade names, patents or trademarks to another subsidiary in, say, Delaware and then pays a fee to the Delaware company in return for the use of the name or mark. Often the subsidiary companies do not produce anything tangible and have little or no staffing. Such activity reduces the parent company's income and tax in the place of its business, as the fee is a deductible business expense[33]. Geoffrey Inc. is incorporated in Delaware and is a wholly owned subsidiary of Toys "R" Us, a global company incorporated in the US state of New Jersey. For example, Geoffrey Inc. owns several trademarks - including Geoffrey, the Toys "R" Us giraffe - and trade names (including

Toys "R" Us). Toys "R" Us pays royalties to Delaware-based Geoffrey Inc. to use the trademark and trade name. The tax impact of this is to reduce Toys "R" Us's taxable income in places where royalty payments are tax deductible, and shift it to Delaware, which does not tax royalty income.

Summary and Discussion

This paper has sought to draw attention to the role of transfer pricing in facilitating tax avoidance. By collecting together some of the scattered evidence of the nature and extent of scope of transfer pricing in relation to tax avoidance it has sought to give greater visibility to the role of transfer pricing in transferring wealth. This paper has endeavoured to show how transfer pricing is not just an accounting technique, but also a method of resource allocation and avoidance of taxes that affects distribution of income, wealth, risks and quality of life. By shedding some light upon the dark side of transfer pricing, our intention has been to stimulate a closer and more critical consideration of the ramifications of transfer pricing practices, and thereby encourage more informed consideration of how these might be regulated in a more socially attentive and responsible manner.

Recent years have seen considerable decline in the headline rates of corporation tax (KPMG, 2009), but this does not appear to have checked the corporate desire to avoid taxes. In more advanced economies, despite record profits, the tax revenues from corporate taxes as a percentage of the GDP and effective tax rates have declined, and transfer pricing practices may provide a plausible explanation for this decline (Mitchell and Sikka, 2005; KPMG, 2009b). As rational economic actors companies continue to structure their transactions to exploit tax differentials in diverse geographical jurisdictions and some observers claim that often "intra-company pricing crosses the line from tax avoidance into outright tax evasion" (Forbes, 28 August 2009). The comparatively well-off states are responding with aggressive audits and legal action. The US tax authorities recruited 1,200 additional staff in 2009 and a further 800 in 2010 to scrutinise transfer prices (CFO Magazine, 1 September 2009[34]). In contrast, many developing countries lack the resources to deploy greater manpower and hence are not in a position to adequately scrutinise the transfer pricing games. The evidence cited in this paper suggests that the traditional representation of transfer pricing as ‘neutral’ (OECD, 1979) or as having “no direct effect on the entire company’s reported profit” (Garrison et al., 2005, p. 654) is problematic or, at best, aspirational , as in practice, it can enable companies to report higher earnings to appease stock markets and maximize executive remuneration, but the loss of tax revenues curtails the ability of the state to provide public goods and alleviate poverty. Faced with corporate resistance some states may assign higher rates of taxes to wages, consumption, savings and less mobile capital, which in turn can breed resentment and undermine the social legitimacy of the state. Thus transfer pricing is at the heart of the debates about legitimacy of the state, social responsibility and accountability of corporations.

Globalization has encouraged convergence around the arm’s length principle, but relatively few corporations dominate global trade and independent prices for intermediate goods are not easy to formulate. This is compounded by the routing of financial transactions through subsidiaries and affiliates in offshore tax havens, which may have little economic substance. Companies are also placing intellectual property and intangible assets in tax havens and subsequently charging royalties and rents to shift profits. As low/no tax jurisdictions, tax havens have little direct interest in monitoring transfer pricing practices to ensure that they comply with the arm’s length principle. The emergence of offshore tax havens poses new challenges to conventional ideas about transfer pricing and merits a closer look. Such scrutiny could be aided by corporate disclosures, but corporate financial reports rarely provide any meaningful information about transfer pricing practices (Tang and Zhao, 2001) even though it could affect estimates of future cash flows, risks, returns and regulatory action. Accounting standard setters (e.g. UK Accounting Standards Board, 1995; International Accounting Standards Board, 2003), dominated by accounting firms and large corporations, do not require companies to provide information about transfer pricing practices. Apparently fearful of being portrayed as anti-business the UK government has also resisted pressures to introduce legislation requiring companies to publish details of their transfer pricing policies (Hansard, UK House of Commons Debates, 14 February 2006, col. 1862) or tax calculations (Hansard, UK House of Commons Debates, 15 February 2006, col. 2083). In this vacuum, NGOs have taken-up the challenge of drafting alternative accounting standards and demanding that companies publish information to show their profits, assets, liabilities, tax payments and employees for each country of their operation and disclose their transfer pricing practices (Association for Accountancy & Business Affairs, 2003; Global Witness, 2005).

International trade has the capacity to provide increased investment, employment and economic development. However, it can also impoverish societies through tax avoidance and capital flight. The darker side of transfer pricing has attracted the attention of NGOs (for example, Global Witness, 2005; Action Aid, 2009; Christian-Aid, 2008, 2009), and non-accounting literatures (for example, Baker, 2005; Brittain-Catlin, 2005; Kar and Cartwright-Smith, 2008) and have linked transfer pricing practices with tax avoidance, capital flight and poverty. They have even been joined in this by some institutional investors (Henderson Global Investors, 2005a, 2005b). In contrast, the role of transfer pricing in tax avoidance, capital flight and its social implications receives little attention in the accounting literature. Indeed, in the accounting literature, there is a deafening silence on the involvement of accounting techniques in widening social inequalities and limiting the resources available for public goods. Seemingly, transfer pricing is taught without any consideration of its social and political context and its capacity to transfer wealth through tax avoidance (Tippett and Wright, 2006; Sikka et al., 2007). In contrast, we have placed transfer pricing at the heart of conflicts over the allocation of resources that involve corporations, stock markets, company executives, business advisers and the state. Transfer pricing practices, we have argued, merit close attention because they articulate competing claims on economic surpluses in the shape of corporate earnings, rates of return, dividends, executive rewards, taxes, social welfare rights and the ability of states to provide public goods.

Some of the literature urges nation-states to eliminate tax differentials in the hope that this would check the tendency to shift profits to low tax jurisdictions (Borkowski, 1997). Such a prescription would lead to a race-to-the-bottom where global corporations would pay little or no tax and the burdens would be shifted onto less mobile capital, labour, consumption and savings. The proposal neglects other avenues of reform and pressures from domestic politics which have persuaded states to secure social legitimacy and stability by underwriting particular social settlements, welfare rights and obligations. Admittedly, globalization has added complexities to attempts to compute local costs as “arm’s length prices are often difficult to establish for many intermediate goods and services … arm’s length standard has become administratively unworkable in its complexity. As a result, the arm’s length standard rarely provides useful guidance regarding economic value” (Avi-Yonah and Clausing, 2007, p. 7). In response, some US states have implemented “formulary apportionment” where companies are taxed on the basis of their economic activity and income within a particular geographic jurisdiction rather than arbitrary allocation of costs (Picciotto, 1992a; Mintz, 1998; Avi-Yonah and Clausing, 2007). Such models could be applied within emerging super states, such as the European Union, but cannot easily address the underlying cause of transfer pricing problems i.e. the systemic conflict between transnational corporations, state, markets and a variety of diverse stakeholders over the allocation of economic surpluses.

The use of transfer prices to shift capital and avoid taxes also poses some fundamental questions about the quality of national economic statistics. Most governments seek to steer the economy by using data on imports, exports, national income, corporate profitability, balance of payments and terms of trade. However, the quality of such data is problematized by corporate transfer pricing policies. By routing paper transactions through tax havens or no/low-tax jurisdictions companies are not necessarily engaging in any new production of goods or services, but such practices significantly change the economic statistics used by governments to manage local economies.

Overall, we would suggest that research into politics of transfer pricing presents considerable opportunities for illuminating capital flight, tax avoidance, complexities of globalization and the deepening crisis of the state. Such a research agenda would place transfer pricing in broader social, political and organizational contexts and show how with the support of professionals (e.g. accountants, lawyers) accounting techniques are mobilized to allocate and retain wealth. The professional experts offer technical services, tax planning and advice on compliance with the rules, but as profit seeking actors they also have an interest in offering novel interpretations of rules and marketing transfer pricing schemes to enable companies to avoid taxes. The use of transfer pricing to avoid taxes poses challenges to professional and corporate claims of acting as socially responsible organizations. It is difficult to reconcile claims of social responsibility with everyday corporate routines and processes that divert tax payments away from society to shareholders. Such conflicts are a reminder of the pivotal role of professionals and accounting techniques in shaping distribution of income and wealth. It would be useful to examine daily corporate routines and processes that normalize tax avoidance aspects of transfer processing and deprive democratically elected governments of vital revenues for social development. The tendency to link executive rewards to corporate earnings is likely to encourage search for complex transfer pricing schemes and tax avoidance strategies. Such practices may enrich a few people but also deprive millions of people of clean water, sanitation, education, healthcare, pensions, security, transport and public goods. Transfer pricing also provides a lens for studying the complex and contradictory relationship between the state and corporations. The state is the ultimate guarantor of capitalism and supports capitalist enterprises not only by bailing out distressed enterprises (e.g. banks) but by also providing social infrastructure, security, legal system and social stability conducive to the production of economic surpluses. Such activities can only be financed through collection of adequate tax revenues, but the net effect of many corporate transfer pricing strategies is to deprive the state of the tax revenues and undermine its ability to provide public goods and an environment conducive to smooth accumulation of economic surpluses. Thus the politics of transfer pricing draw attention to the complex and contradictory role of the state and corporations in the recurring crisis of capitalism.

APPENDIX 1
Advanced Pricing Agreements in the UK

Year	Number of APAs signed	Number of APAs In force at year-end
1996	3	8
1997	2	10
1998	3	13
1999	2	15
2000	10	25
2001	11	36
2000-01	6	5
2001-02	9	14
2002-03	6	16
2003-04	10	22
2004-05	10	22
2005-06	7	18
2006	14	33
2007	16	37
2008	15	46

Sources: Hansard, UK House of Commons Debates, 17 June 2002, col. 137; 6 Jul 2006, col. 1258; 5 January 2010, col. 178.

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NOTES

[1]In textbooks (e.g. Horngren et al., 2002; Atkinson, Kaplan and Young, 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 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.

[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.

[3] The counterargument, with which we have little sympathy, is that because international corporations are well resourced to negotiate with tax authorities they have become a ‘soft target’ for over-zealous tax authorities. Accordingly, it is argued that companies may be investigated for the years preceding entry into APAs and that “tax probes can catch companies unawares and can be very intrusive and expensive…while the protection of national interests is a legitimate claim, the interpretation and enforcement of an ever changing and complex transfer pricing legislation can be uneven and sometimes too prejudiced and Machiavellian’ (Mehafdi, 2000: 376). Compared to systematic manipulation of transfer pricing, evidence of such cases is scant, and many developing countries lack resources for effective audits of transfer pricing practices of multinational companies.

[4] Transfer prices can also provide a cover for illicit and anti-social corporate behaviour (United Nations Department of Economic and Social Affairs, 1976, paras 51-59).

[5]http://www.nytimes.com/2009/04/08/business/global/08tax.html?pagewanted=1&_r=1&sq=tax&st=nyt&scp=2; accessed 7 April 2009.

[6] According to the OECD guidelines this is taken to mean that a transfer price should be the same as if the two companies involved were indeed two independents, not part of the same corporate structure. The OECD Model Tax Convention is considered to be the framework for bilateral treaties between OECD countries, and is also adopted by many non-OECD governments

[7] Therefore companies and tax authorities use a variety of proxies, such as cost Plus, Resale Price, Profit Split , comparable uncontrolled price method (CUP), resale price method (RPM), cost plus method (CPM), Profit split method (PSM) and Transactional net margin method (TNM) to estimate transfer prices.

[8] Court cases such as the US case of *Eli Lilly & Co v. Commissioner, 84 T.C. 996 (1985)* draw attention to difficulties of assigning a price to the use of company specific intangible assets.
[9] The language of law, in common with any other language, is capable of alternative interpretations and cannot fix the meaning of 'transfer pricing' and its components in any permanent sense (Volsinov, 1973).
[10]Britain's 100 biggest quoted companies are estimated to have over 15,000 subsidiaries (Financial Times, 30 May 2006)
[11]Subsidiaries in high tax countries can also be financed by debt to enable transfers of profits.
[12] For a list of tax havens see Tax Justice Network (2005) and Baker (2005).
[13] The most favourite offshore vehicle is the International Business Corporation (IBC) which can be owned by a trust. The trusts are frequently fronted by accountants, lawyers and nominee directors. There are no public documents and the identities of the real owners are not known.
[14] From I June 2007 China introduced a new corporate bankruptcy law, which is primarily based on western models (People's Daily Online, http://english.people.com.cn/200608/27/eng20060827_297276.html; accessed 29 Aug 2009)
[15]http://www.reuters.com/article/companyNewsAndPR/idUSBJA00020220090115; accessed 20 July 2009.
[16] http://business.globaltimes.cn/china-economy/2009-07/453131.html; accessed 23 September 2009.
[17] http://www.gov.cn/english/////////////////2005-12/31/content_143759.htm; accessed 31 January 2009.
[18]http://sientechina.china.com.cn/english/business/242071.htm; accessed 23 September 2009.
[19] http://www.chinadaily.com.cn/english/doc/2004-11/25/content_394744.htm; accessed 30 November 2008.
[20] http://www.sptimes.ru/index.php?action_id=2&story_id=21057; accessed on 31 March 2009.
[21] Russia is the world's second largest exporter of oil, after Saudi Arabia.
[22] Developing countries are estimated to losing between $858 billion and $1 trillion through illicit financial outflows each year, mainly to western countries (Kar and Cartwright-Smith, 2008). Around $500 billion is estimated to be lost through a variety of tax avoidance schemes (Baker, 2005; Cobham, 2005).
[23] "Management Foresight" is management's "strategy to provide customers "end to end bundled services over a global network ….. nothing more than management's vision to create a horizontally and vertically integrated corporate structure to provide a full range of Telecom services to its customers" (United States Bankruptcy Court Southern District of New York, 2004, p. 12).
[24] The case established that the tax authorities can be aggressive and go beyond the terms of cost sharing agreements to determine costs and taxable profits.
[25] http://www.irs.gov/newsroom/article/0,,id=162359,00.html; accessed 12 April 2009.
[26] http://www.usdoj.gov/opa/pr/2001/January/041civ.htm; accessed 18 April 2009
[27]http://www.marketwatch.com/News/Story/Story.aspx?dist=newsfinder&siteid=google&guid=%7B1B94F37A-E4CC-4B45-95EA-110813CD53B8%7D&; accessed 18 April 2008.

[28] The supermarket's margin is 39 pence.

[29] http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=6080848-828-8267&SessionID=2pC3WqfwJUCNjR7; accessed 30 July 2009.

[30]http://www.theregister.co.uk/1999/08/06/inland_revenue_probes_ibm/; accessed 20 April 2008.

[31]Following critical press comments, Microsoft reregistered its Round Island One and Flat Island Company subsidiaries as companies with unlimited liability. Under Irish law, unlimited companies have no obligation to publicly file their accounts (http://www.finfacts.com/irelandbusinessnews/publish/article_10005150.shtml; accessed 10 March 2008).

[32]http://www.mayerbrownrowe.com/taxcontroversy/pdf/westreco_memoopinion.PDF; accessed 10 March 2008

[33] The Delaware company may then lend the money back to the parent company or send it back in the form of dividends to achieve more tax advantages for the parent. The interest that the parent pays on the loan is an expense that can be deducted from net income, thus reducing taxes further. The dividends that the parent receives back from the Delaware corporation do not have to be recognized by the parent as taxable income. In either case, the parent corporation has successfully transferred income earned in one jurisdiction into tax-free income that it can use without restriction.

[34] http://www.cfo.com/article.cfm/14292573?f=most_read; accessed 18 September 2009.