

TAX OPTIMIZATION THROUGH TRANSFER PRICING, COMMON AND MANIPULATIVE PRACTICE

Cuzdriorean Dan Dacian

Babeş-Bolyai University, Faculty of Economics and Business Administration, Cluj-Napoca, Teodor Mihali 58-60, dan.cuzdriorean@econ.ubbcluj.ro, 0744615577

Jurcău Anca Sabina

Babeş-Bolyai University, Faculty of Economics and Business Administration, Cluj-Napoca, Teodor Mihali 58-60, anca.jurcau@econ.ubbcluj.ro, 0740272465

This paper is about how multinational enterprises choose transfer prices in the presence of differential corporate income tax rates. A transfer price is a value placed on the goods which are traded between divisions of an organization. We review and extend the core literature transfer price manipulation to avoid taxes. Manipulations are often used by multinational enterprises causing substantial long term detriment to a country's revenue raising process. This paper attempts to make the subject of transfer pricing accessible to researchers and others interested.

Keywords: transfer pricing, tax optimization, tax reduction

Cod JEL: H21, M41

Research methodology: The object of the present investigation is transfer pricing and tax optimization through transfer pricing.

The investigation technique: research literature, laws, logical analysis, generalization. While evaluating transfer pricing the English, French and Romanian literature was used. As a research component, we approached the deductive method (extracting conclusions based on available data), and the research type is the fundamental one; the utility of such research, although it does not identify a problem with the purpose of solving it, is reflected in its contribution to the future developments of this research, by ensuring premises for forthcoming studies.

1. Introduction

Multinational enterprises have the ability to use transfer pricing policies to maximize their global profits in a world characterized by different international tax rates, governmental regulations, foreign exchanges rates, currency manipulation and other economic, cultural and social factors.

Over the years, transfer pricing of goods has undeniably become an important international business issue of multinational enterprises and a nightmare problem for tax authorities, relating to the fact that multinational enterprises could use these transfer prices to shift profits between related parties through cost of goods sold, having at their disposal several alternative methods of structuring and financing their foreign investments to achieve tax reduction primarily. These alternative methods have important tax implications and there is considerable evidence that tax considerations strongly influence the choice that companies make.

2. The gist and means of transfer pricing according to literature review

Transfer prices are the prices at which an enterprise transfer goods and intangible property or provides services to associated enterprises.

This is defined as the price paid in a business transaction, whether for tangible property, intellectual property or the provision of services – between companies under related party control (Abdallah, 2004) and is often a significant component used in assessing performance within large segmented firms (Langfield-Smith, Smith, 2005).

According to literature review, the studies regarding transfer pricing deals with: tax accounting studies investigating the degree to which national tax rate differentials lead to transfer pricing manipulation and income shifting (Klassen, Lang, Wolfson, 1993; Harris, 1993; Iacob, 1996; Swenson, 2001; Gupta, Mills, 2002); tax regulations as one of the environmental factors

(Emmanuel, Mehafdi, 1994; Cravens, Shearon, 1996; Cravens, 1997); optimal transfer pricing method from a fiscal point of view (Swenson, 2001; Van Mens, Porquet, 2001; Douvier, 2005); maximize the value of the corporation (Michaels, 2005).

Previous studies have also provided evidence regarding what types of multinational enterprises are more likely to manipulate transfer prices. Conover and Nichols (2000) investigated the effect of firm size on the use of transfer pricing to shift income and found that larger companies are more likely to shift income through transfer pricing. Jacob (1996) confirmed that multinationals with the greatest level of intracompany transfers had the most opportunities and the greatest incentive to shift income through transfer prices.

3. Tax optimization through transfer pricing. Illustrations

Transfer pricing strategies are now commonly employed among multinational enterprises in today's global marketplace. This practice is largely due in part to the tax and other benefits that can be obtained.

The income tax policies and of course, regulations of different foreign countries are not the same and the so called international taxation has a significant effect on multinational enterprises in making their long term management decisions. Taxation affects where an multinational enterprises invests, how it markets its products, how to finance and the choice of a transfer price (Muller, Gernon, Meek, 1997) and of course, tax considerations strongly influence the choice that multinational enterprises make (Hines, 1999).

The goals of transfer pricing within multinational enterprises can be: internal goals and external; including here performance evaluation of subsidiaries and their managers, motivating managers as internal reasons and to reduce taxes, reduce the foreign and domestic tax bill and strengthen the foreign subsidiary as external reasons. The multinational enterprises also use transfer pricing to reduce foreign exchange risk and to put themselves in a better position to relative to its competitors, to hide fiscal success, for profit maximization and tax burden minimization (Dawson, 2000; Mehafdi, 2000).

It is important to note that following criteria must be met for establishing an efficient international transfer pricing system for foreign operations:

- It should increase the global profit of the multinational enterprise by minimizing total income tax liability, reducing the foreign exchange losses, minimizing the international transaction costs and paying fewer tariffs on both imports and exports.
- It should motivate foreign subsidiary managers to increase their efficiency and maximize their profit according with the objectives of top management and in the same time helping the foreign subsidiary to compete with other firms.

In an attempt to minimize taxes, the use of transfer pricing among multinational enterprises is often abusive, consider the statistics from Baker (2005) and the study undertaken by Dawson (2000), Hansen (1992), Mehafdi (2000) and the primarily scope is to reduce taxation. A more recently study, undertaken by Ernst and Young (2008) in our country suggest that companies use transfer pricing as tax optimization and that tax considerations strongly influence the choice that companies make (over half (55%) of all respondents point this answer).

Many of these methods are legal and we refer to them as creative accounting practices mostly, transfer pricing manipulation being the practice of obscuring the actual value of transactions so as to generate the most profit for the businesses involved.

Multinational enterprises have been commonly associated with transfer pricing manipulations because of their dominant position in the market place for particular products and services, and because they have more opportunities, through their world-wide networks of related companies, to carry out transactions at different prices from those between businesses independent of each other.

But how can tax reduction be achieved using transfer pricing?

The answer is very simple: by transferring goods to countries with low income tax rates at the lowest possible transfer price and by transferring goods out of these countries at the highest possible transfer price. In countries with high income tax rates, goods transfer into the country should be at highest prices so that the cost to the buying subsidiary will be high, to minimize its eventual tax liability.

These practices have an important effect on reallocating taxable income from countries with high tax rates to countries with low tax rates which influences the revenue of the countries and also changes the timing of income recognition for tax purposes.

To illustrate the income tax effects using the transfer prices for cross-border activities we can use the following example. Supposing that the Cyprus subsidiary of a German multinational enterprise produces 15.000 units and sells 12.500 units to the Sweden subsidiary, also owned by the German multinational company, at 20€ a unit. The Sweden subsidiary sells these units for 40€ per unit to an unrelated customer.

Considering that the income tax rate of Cyprus is 10 percent and that of Sweden is 28 percent, is obvious that using a higher transfer pricing between the two subsidiaries there is a tax reduction effect.

As can be seen from Table 1.a, with the low, original, transfer price, the Cyprus subsidiary sells at 20€ per unit and pays income taxes of 13.000€, the Sweden subsidiary pays income taxes of 28.000€ and the multinational company pays a total income taxes of 41.000€.

Table 1.a The Tax Effect of Transfer Pricing Strategies

Transfer Price (20€)	Cyprus Subsidiary	Sweden Subsidiary	The multinational company
Sales (12.500 units at 20€ per unit)	250.000 €	500.000 €	500.000 €
Less Cost of Goods Sold	75.000 €	250.000 €	75.000 €
Gross profit	175.000 €	250.000 €	425.000 €
Less operating expenses	45.000 €	150.000 €	195.000 €
Net income before tax	130.000 €	100.000 €	230.000 €
Income taxes (10% & 28%)	13.000 €	28.000 €	41.000 €
Net income after tax	117.000 €	72.000 €	189.000 €

If the transfer price between the Cyprus subsidiary and the Sweden subsidiary grows up at 25€ per unit, as can be seen from Table 1.b, the Cyprus' income taxes go up by 6.250€ to 19.250€, but the Sweden's taxes go down by 17.500€ to 10.500€. Therefore, the total income taxes go down by 11.250€, from 41.000€ to 29.750€. The consequences of charging a higher transfer price are a decrease of total income taxes by 11.250€ and an increase of consolidated net income by the same amount.

Table 1.b The Tax Effect of Transfer Pricing Strategies

Transfer Price (25€)	Cyprus Subsidiary	Sweden Subsidiary	The multinational company
Sales (12.500 units at 25€ per unit)	312.500 €	500.000 €	500.000 €
Less Cost of Goods Sold	75.000 €	312.500 €	75.000 €
Gross profit	237.500 €	187.500 €	425.000 €
Less operating expenses	45.000 €	150.000 €	195.000 €
Net income before tax	192.500 €	37.500 €	230.000 €
Income taxes (10% & 28%)	19.250 €	10.500 €	29.750 €
Net income after tax	173.250 €	27.000 €	200.250 €

To eliminate the income taxes in the foreign subsidiary with the highest taxation rate, in our case the Sweden subsidiary, is very important to determine the optimum transfer price that can be used in cross-border intracompany transactions. As can be seen from Table 1.c, at the transfer price of 28€ the net income of the Sweden subsidiary reaches the zero level, therefore this subsidiary, even it is located in a country with a high taxation, pays no income taxes. At this transfer price, the total income taxes of the multinational company reduces by 18.000€, from 41.000€ (at the transfer price of 20€) to 23.000€, the total net income growing up by the same amount.

Table 1.c The Tax Effect of Transfer Pricing Strategies

Transfer Price (28€)	Cyprus Subsidiary	Sweden Subsidiary	The multinational company
Sales (12.500 units at 28€ per unit)	350.000 €	500.000 €	500.000 €
Less Cost of Goods Sold	75.000 €	350.000 €	75.000 €
Gross profit	275.000 €	150.000 €	425.000 €
Less operating expenses	45.000 €	150.000 €	195.000 €
Net income before tax	230.000 €	0 €	230.000 €
Income taxes (10% & 28%)	23.000 €	0 €	23.000 €
Net income after tax	207.000 €	0 €	207.000 €

3. Conclusions

Multinational enterprises may use their own strategies or manipulation of transfer pricing to take advantages of differences in tax rates and other factors in different countries to reduce their tax liability and achieve their corporate goals.

Very substantial adjustments have frequently been made by the use of transfer pricing legislation. Tax authorities should be conscious of the existence of this powerful although not all embracing weapon in relation to international tax problems.

Minimization of taxes through the use of transfer pricing is and will continue to be a common and pervasive practice among multinational enterprises. It is clear that although regulations are in place by OECD to make the practices we refer to, more uniform, the practices aimed at minimizing taxes can be circumvented and may sometimes be used to avoid taxation.

References

1. Abdallah, W.M. (2004), Critical Concerns in Transfer Pricing and Practice, London, Praeger Publishers

2. Baker, R.W. (2005), *Capitalism's Achilles heel: Dirty money and how to renew the free-market system*, Hoboken, NJ: John Wiley and Sons
3. Cravens, K., and Shearon, W.T. (1996), An outcome-based Assessment of International Transfer Pricing Policy, *The International Journal of Accounting* 31, 4, 419-443
- Cravens, K. (1997), Examining the role of transfer pricing as a strategy for multinational firms, *International Business Review* 6, 2, 127-145
4. Conover, T. L. and Nichols, N. B. (2000), A Further Examination of Income Shifting Through Transfer Pricing Considering Firm Size and/or Distress, *The International Journal of Accounting*, vol. 35, 189-211
5. Dawson, P.C. (2000), Transfer price determination in a multinational corporation: Decentralized decision-making, agency costs, and strategic interaction [Electronic version], *Dissertation Abstracts International*, 60(8), 3069A
6. Douvier P.J. (2005), France: Current and future transfer pricing measures, *International Transfer Pricing Journal* 12, 2, 72-77
7. Emmanuel C.R. and M. Mehafdi (1994), *Transfer Pricing*, London, Academic Press Ltd., 172.
8. Gupta, S., & Mills, L.F. (2002), Corporate multistate tax planning: benefits of multiple jurisdictions, *Journal of Accounting and Economics* 33, 117-139
9. Hansen, D.R., Crosser, R.L., & Laufer, D. (1992), Moral ethics v. tax ethics: The case of transfer pricing among multinational corporations [Electronic version], *Journal of Business Ethics*, 11(9), 679-686
10. Harris, D. G. (1993), The impact of US tax law revision on multinational corporations, capital location and income shifting decisions, *Journal of Accounting Research* 31 Supplement, 111-140.
11. Hines, James R., Jr. (1999), Lessons from behavioral responses to international taxation, *National Tax Journal* (Washington) (June): 305-22
12. Jacob, J. (1996), Taxes and Transfer Pricing: income shifting and the volume of intrafirm transfers, *Journal of Accounting Research* Autumn, 34, 2, 301-313
13. Klassen, K., Lang, M. and Wolfson, M. (1993), Geographic income shifting by multinational corporations in response to tax rate changes, *Journal of Accounting Research*, 31(Supplement), 141-173
14. Langfield-Smith, K. And Smith, D. (2005), Performance Measures in Supply Chains, *Australian Accounting Review*, 15(1), 39-54
15. Mehafdi, M. (2000), The ethics of international transfer pricing [Electronic version], *Journal of Business ethics*, 28(4), 365-381
16. Michaels, A. (2005), Strategic Planning and Business Strategy, www.e-competitors.com; Retrieved 20 September 2005
17. Mueller, Gerhard G., Helen Gernon, and Gary Meek (1997), *Accounting. An international perspective*, 4th Edition. Chicago: Richard D. Irwin, Inc.
18. Swenson, D. (2001), Tax reforms and evidence of transfer pricing, *National Tax Journal* March, 7-25.
19. Van Mens, H. & Porquet, F.G. (2001), Current European tax issues, *European Taxation*, 335-338.

www.ey.com

Investing in people! PhD scholarship, Project co-financed by the European Social Fund, SECTORIAL OPERATIONAL PROGRAMME HUMAN RESOURCES DEVELOPMENT 2007 – 2013, Babeş-Bolyai University, Cluj-Napoca, Romania