CHAPTER 12

International Taxation and Transfer Pricing

> Consider the case of a manufacturing company that was evaluating sites for new European operations. The decision came down to three locations in different countries, all roughly equal from a pretax viewpoint. Management made the final choice, but didn't consult with their tax specialist team until after the deal was done.
>
> Bad move. Turns out they picked the very worst of the three from a tax perspective, ending up with a two percentage point increase in their effective tax rate—two points of gross margin down the drain. And because their tax specialists weren't consulted until the last minute, there was no turning back. Space had already been procured, employees hired and contracts signed.[1]

Of all the environmental variables that financial managers must contend with in multinational operations, only foreign exchange is as influential as taxation. Tax considerations strongly influence decisions on where to invest, what form of business organization to use, how to finance, when and where to recognize elements of revenues and expense, and what transfer prices to charge.

With the possible exception of cost of goods sold, taxation is the largest expense of most businesses. Thus, it makes sense for management to minimize international taxes whenever possible. Financial managers must also contend with special rules regarding the taxation of foreign-source income. Moreover, international tax agreements, laws, and regulations are constantly changing. Changes in one country's tax provisions have complex and wide-ranging effects in a multinational tax-planning system, and computer-based simulation systems are essential aids to management.

Because it is not possible in a single chapter to provide a working knowledge of the major tax provisions in all of the world's economically important countries, we limit our discussion here to some of the major variables that financial managers need to consider in tax planning for multinational operations. These variables include major differences

[1] Deloitte, "Breathing Lessons: Make Time for Taxes. It's Worth It." (May 8, 2007), www.deloitte.org/dtt/cda/doc/content/Breathing%20Lessons(1).pdf.

in national tax systems (i.e., how countries tax businesses operating in their jurisdictions), national attempts to address the issue of double taxation (i.e., how countries tax the foreign-source income of their business entities), and arbitrage opportunities between national tax jurisdictions for multinational firms. Transfer pricing, in addition to its role in minimizing multinational corporate taxes, should be considered in the broader context of strategic planning and control.

INITIAL CONCEPTS

The maze of laws and regulations that govern the taxation of foreign corporations and profits earned abroad rests on a few basic concepts. These include notions of tax neutrality and tax equity. *Tax neutrality* means that taxes have no effect (are neutral) on resource-allocation decisions. That is, business decisions are driven by economic fundamentals, such as rate of return, rather than tax considerations. Such decisions should result in an optimal allocation of resources: When taxes influence the allocation of resources, the result will probably be less than optimal. In reality, taxes are seldom neutral.[2]

Tax equity means that taxpayers who are similarly situated should pay the same tax, but there is much disagreement over how to interpret this concept. For example, is a foreign subsidiary simply a domestic company that happens to operate abroad? If so, then foreign- and domestic-source income should be taxed at the same parent-country rate. Or is a foreign subsidiary a foreign company that happens to be owned by a domestic one? In this case, foreign-source income should be taxed the same as other companies in that country, that is, at the foreign country's tax rate. We shall find that actual international tax practices waver between these two extremes.

DIVERSITY OF NATIONAL TAX SYSTEMS

A firm can conduct international business by exporting goods and services or by making direct or indirect foreign investments. Exports seldom trigger a tax exposure in the importing country, because it is difficult for importing countries to enforce taxes levied on foreign exporters. On the other hand, a company that operates in another country through a branch or an incorporated affiliate subjects itself to that country's taxes. The effective management of this tax exposure requires an understanding of national tax systems, which differ greatly among countries. Differences range from types of taxes and tax burdens to differences in tax assessment and collection philosophies.

Types of Taxes

A company operating abroad encounters a variety of taxes. *Direct taxes*, such as income taxes, are easy to recognize and normally are disclosed on companies' financial statements. *Indirect taxes*, such as consumption taxes, are not so clearly recognized or as frequently disclosed. Typically they are buried in "other" expenses. Exhibit 12-1 illustrates the differential impact of direct and indirect taxes on pretax and after-tax

[2] See, for example, PriceWaterhouseCoopers, *Paying Taxes 2009: The Global Picture* (2008), www.pwc.com/extweb/pwcpublications.nsf/docid/E3885850CC074F43852574F80055639C/$File/Paying_Taxes_2009.pdf.

EXHIBIT 12-1 Income Effects of Direct vs. Indirect Taxes

	Direct	Indirect
Revenues	250	250
Expenses	150	190
Pretax income	100	60
Direct taxes (40%)	40	-0-
After-tax income	60	60

income. In comparing investment performance between countries, the focus should be on after-tax income.

The *corporate income tax* is probably more widely used to generate government revenue than any other major tax, with the possible exception of customs duties. Since the mid-1980s, however, the international trend has been a lowering and converging of income tax rates. Fueling this trend is the recognition that reduced tax rates increase the global competitiveness of a country's business enterprises and create an attractive environment for international business. Indeed, the integration of the world economy and the increasing ability of businesses to move from high-tax environments to low-tax ones constrain a country's ability to set higher rates than elsewhere. Exhibit 12-2 shows national income tax rates for selected countries.

Withholding taxes are taxes imposed by governments on dividend, interest, and royalty payments to foreign investors. For example, assume that a country has a 10 percent withholding tax on interest paid to foreign investors. The investors would receive only 90 percent of the interest paid by the bonds. While legally imposed on the foreign recipient, these taxes are typically withheld at the source by the paying corporation, which remits the proceeds to tax collectors in the host country. Because withholding taxes may hinder the international flow of long-term investment capital, they are often modified by bilateral tax treaties.

The *value-added tax* is a consumption tax found in Europe and Canada. This tax is typically levied on the value added at each stage of production or distribution. It applies to total sales less purchases from any intermediate sales unit. Thus, if a Norwegian merchant buys 500,000 krone of merchandise from a Norwegian wholesaler and then sells it for 600,000 krone, the value added is 100,000 krone, and a tax is assessed on this amount. Companies that pay the tax in their own costs can reclaim them later from the tax authorities. Consumers ultimately bear the cost of the value-added tax. Exhibit 12-3 shows how the value-added tax works.

Border taxes, such as customs or import duties, generally aim at keeping domestic goods price competitive with imports. Accordingly, taxes assessed on imports typically parallel excise and other indirect taxes paid by domestic producers of similar goods.

The *transfer tax* is another indirect tax. It is imposed on transfers of items between taxpayers and can have important effects on such business decisions as the structure of acquisitions. For example, business acquisitions in Europe are often made through the purchase of shares rather than the underlying net assets. More variations in structure are found in U.S. acquisitions because transfer taxes are less important in the United States.

EXHIBIT 12-2 Corporate Income Tax Rates

Country	(%)	Country	(%)	Country	(%)
Argentina	35	Greece	22/29	Philippines	30
Australia	30	Honduras	30	Poland	19
Austria	25	Hong Kong	16.5	Portugal	25
Bahrain	0	Hungary	16	Romania	16
Bangladesh	30	Iceland	15	Russia	20
Belgium	33.99	India	33.99	Saudi Arabia	20
Bolivia	25	Indonesia	28	Singapore	18
Brazil	34[a]	Ireland	12.5	Slovak Republic	19
Bulgaria	10	Israel	26	Slovenia	21
Canada	33.5[b]	Italy	31.4[d]	South Africa	28[g]
Cayman Islands	0	Japan	40.69[e]	Spain	30
Chile	17	Korea, Republic of	27.5	Sri Lanka	35
China	33	Latvia	15	Sweden	28
Colombia	33	Lithuania	20	Switzerland	19.2[h]
Costa Rica	30	Luxembourg	21[f]	Taiwan	25
Croatia	20	Malaysia	26	Thailand	30
Cyprus	10	Malta	35	Tunisia	30
Czech Republic	20	Mexico	28	Turkey	20
Denmark	25	The Netherlands	25.5	Ukraine	25
Dominican Republic	25	New Zealand	30	United Kingdom	28
Ecuador	25	Norway	28	United States	35/40[i]
Egypt	20	Oman	12	Uruguay	25
Fiji	31	Pakistan	35	Venezuela	34
Finland	26	Panama	30	Vietnam	25
France	33.33	Papua New Guinea	30	Zambia	35
Germany	29.51[c]	Peru	30		

Note:

A simple comparison of tax rates is not sufficient for assessing the relative tax burdens imposed by different governments. The method of computing the profits to which the tax rates will be applied (the tax base) should also be taken into account.

These rates do not reflect payroll taxes, social security taxes, net wealth taxes, turnover taxes, and other taxes not levied on income.

[a]*The sum of income tax and social contribution tax.*

[b]*Includes provincial income taxes.*

[c]*Includes local trade tax plus solidarity tax.*

[d]*The sum of income tax and regional tax rates.*

[e]*Includes corporate income tax and business, perfectural, and municipal taxes.*

[f]*Includes employment fund contribution and municipal business tax.*

[g]*Includes corporate income tax rate and effect of tax on dividends declared.*

[h]*Includes federal, cantonal, and municipal taxes.*

[i]*Federal tax rate is 35 percent State and local income tax rates range from less than 1 to 12 percent. State and local income taxes are deductible in determining federal income taxes, making the average effective tax rate 40 percent.*

Sources: "Tax Rates Around the World," www.worldwide-tax.com (May 31, 2009) and KPMG's Corporate and Indirect Tax Rate Survey 2008, www.kpmg.com/SiteCollectionDocuments/Corporate-and-Indirect-Tax-Rate-Survey-2008v2.pdf.

EXHIBIT 12-3 Value-Added Tax

	Producer	Wholesaler	Merchant	Consumer
Cost	Assume 0	€12.00	€15.60	€21.60
Recoverable VAT	–	2.00	2.60	
Net cost	0	€10.00	€13.00	
Sales price before VAT	€10.00	13.00	18.00	
Value added	€10.00	€ 3.00	€ 5.00	
Value-added tax (20%)	2.00	0.60	1.00	
Sales price after VAT	€12.00	€15.60	21.60	
VAT paid	€ 2.00	€ 2.60	€ 3.60	
Recoverable VAT	0	2.00	2.60	
VAT due	€ 2.00	€ 0.60	€ 1.00	
VAT borne				€ 3.60

Tax Burdens

Differences in overall tax burdens are important in international business. Various statutory rates of income taxation are an important source of these differences, as can be seen in Exhibit 12-2. However, differences in tax rates tell only part of the story. Many other considerations may significantly affect the *effective tax burdens* for multinational enterprises. Differences in national definitions of taxable income are important.

Consider depreciation. In theory, a portion of the cost of an asset is said to expire as the asset is used up to produce revenue. In keeping with the matching principle, this expired cost is recognized as an expense and deducted from its related revenue. Where the asset is consumed equally in each reporting period, an equal portion of its cost is commonly expensed each period for external financial reporting purposes. In the United States, however, a distinction is generally made between depreciation for external reporting and depreciation for tax purposes. As an incentive to invest in capital assets, including commercial buildings, companies in the United States are allowed to use accelerated depreciation methods. In Germany, tax law specifies depreciation rates, and buildings are depreciated in straight-line fashion. Tax law also determines depreciation rates in France, with most assets depreciated on a straight-line basis. However, anti-pollution and energy-saving assets may be depreciated on an accelerated basis.

Another item that accounts for intercountry differences in effective tax burdens relates to the host country's social overhead. To attract foreign investments, less-industrialized countries often assess lower corporate income tax rates than their more industrialized counterparts. However, countries with low direct taxes need to fund government and other social services just like any other country. Therefore, lower direct corporate tax rates usually result in higher indirect taxes or in fewer and lower quality public services. Indirect taxes reduce purchasing power in the local market. Fewer and lower quality public services may impose a higher cost structure on multinational operations. Examples include poor transportation networks, inadequate postal services, ineffective telephone and telecommunications systems, and power shortages.

While more and more governments are reducing marginal corporate tax rates, many also are broadening corporate tax bases. In the real world, effective tax rates seldom equal nominal tax rates. Thus, it is improper to base intercountry comparisons on statutory tax rates alone. Furthermore, a low tax rate does not necessarily mean a low tax burden. Internationally, tax burdens should always be determined by examining *effective* tax rates.

Tax Administration Systems

National tax assessment systems also affect relative tax burdens. Several major systems are currently in use. For simplicity, we will only consider the classical and integrated systems.

Under the *classical system*, corporate income taxes on taxable income are levied at the corporate level and the shareholder level. Shareholders are taxed either when the corporate income is paid as a dividend or when they liquidate their investment. When a corporation is taxed on income measured before dividends are paid, and shareholders are then taxed on their dividends, the shareholders' dividend income is effectively taxed twice. To illustrate, assume that a parent corporation in Zonolia (fictitious), subject to a 33 percent corporate income tax, earns 100 zonos (Z) and distributes a 100 percent dividend to its sole shareholder, who is in the 30 percent tax bracket. Effective taxes paid on the corporate income are determined as follows:

Corporate income	Z100.00
– Income tax at 33%	33.00
= Net income (and dividend paid)	Z 67.00
Dividend income to shareholder	Z 67.00
– Personal income tax at 30%	20.10
= Net amount to shareholder	Z 46.90

Total tax paid on the Z100 of corporate income:

Corporate tax	Z33.00
Individual income tax	20.10
Total	Z53.10

Countries associated with this system include Belgium, Luxembourg, the Netherlands, and Sweden. The recent trend in most developed countries has been to move away from the double taxation of dividend income by adopting either an integrated or an imputation system.

Under an *integrated* system, corporate and shareholder taxes are integrated so as to reduce or eliminate the double taxation of corporate income. The *tax credit*, or *imputation*, system is a common variant of the integrated tax system. In this system, a tax is levied on corporate income, but part of the tax paid can be treated as a credit against personal income taxes when dividends are distributed to shareholders. This tax system is advocated by the European Union and is found in Australia,

Canada, Mexico, and many European countries, including France, Italy, and the United Kingdom.

To see how this tax system works, assume facts similar to that of our Zonolian parent company in the preceding illustration. Further assume that shareholders receive a tax credit equal to 25 percent of dividends received. Based on these assumptions, the total taxes paid is determined as follows:

Corporate income	Z100.00
– Income tax at 33%	33.00
= Net income (and dividend paid)	Z 67.00
Dividend income to shareholder	Z 67.00
+ Tax credit at 25%	16.75
= Grossed-up dividend	Z 83.75
Income tax liability at 30%	Z 25.12
– Tax credit	16.75
= Tax due from shareholder	Z 8.37

Total tax paid on the Z100 of corporate income:

Corporate tax	Z 33.00
Individual income tax	8.37
Total	Z 41.37

This example illustrates a partial imputation system in which double taxation is reduced but not eliminated. Full imputation eliminates double taxation.

The *split-rate* system is another variant of the integrated tax system, where a lower tax is levied on distributed earnings (i.e., dividends) than on retained earnings. Germany once had a split-rate system. Other ways to reduce double taxation are to exempt a percentage of dividends from personal taxation, as Germany does now, or to tax dividends at a lower rate than the personal rate, as in the United States.

Foreign Tax Incentives

Countries eager to accelerate their economic development are keenly aware of the benefits of international business. Many countries offer tax incentives to attract foreign investment. Incentives may include tax-free cash grants applied toward the cost of fixed assets of new industrial undertakings or relief from paying taxes for certain time periods (*tax holidays*). Other forms of temporary tax relief include reduced income tax rates, tax deferrals, and reduction or elimination of various indirect taxes. More-industrialized countries offer targeted incentives, such as Ireland's reduced corporate tax rate for manufacturing operations (10 percent) through the year 2010.[3]

[3] The Irish corporate tax rate is 12.5 percent. The 10 percent preferential tax rate for manufacturing companies will be eliminated after 2010.

Some countries, particularly those with few natural resources, offer permanent tax inducements. These countries include:

1. the Bahamas, Bermuda, and the Cayman Islands, which have no income taxes at all
2. Vanuatu, which has very low income tax rates
3. Hong Kong and Panama, which tax locally generated income but exempt income from foreign sources

Tax Havens and Harmful Tax Competition

For some time, the Organization for Economic Cooperation and Development (OECD) has been concerned about tax competition by certain *tax-haven* countries. The worldwide trend toward both lowering and converging corporate income tax rates is a direct result of tax competition. So is tax competition harmful? Certainly it is beneficial if it makes governments more efficient. On the other hand, it is harmful when it shifts tax revenues away from governments that need them to provide services on which businesses rely. The OECD's main concern has been about tax havens that allow businesses to avoid or evade another country's taxes. So-called *brass plate* subsidiaries have no real work or employment attached to them: They lack *substantial activities* and merely funnel financial transactions through the tax-haven country to avoid another country's taxes.[4]

The OECD lists four factors for identifying a tax haven:

1. No or low taxes on income,
2. Lack of effective exchange of information,
3. Lack of transparency, and
4. No substantial activities.

In 2000, the OECD identified over 40 countries as tax havens. These countries often advertized their no or low tax rates to lure foreign money and had a "don't ask, don't tell" policy regarding foreign income. They often stonewalled requests from other countries who were hunting tax evaders. The OECD applied pressure to so-called "uncooperative" tax havens: those that were unwilling to share information with tax authorities elsewhere and that applied or enforced tax laws unevenly or in secret. Uncooperative tax havens were pressured to adopt practices on the effective exchange of information and transparency. The pressure worked. By 2009, all uncooperative tax havens were removed from the original list.[5]

International Harmonization

Given the diversity of tax systems around the world, the global harmonization of tax policies would seem to be worthwhile. Multinational companies, burdened by the disparities of national taxes, are fueling the pressure for international tax reform. The

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[4] For example, the U.S. Treasury Department estimates that it loses $100 billion a year in tax revenue from companies that ship their income offshore. It is estimated that tax havens have attracted $12 trillion in assets. See "Where Money Goes to Hide," *The Week* (May 8, 2009): 13.

[5] See OECD, "Overview of the OECD's Work on Countering International Tax Evasion" (June 17, 2009) and "Countering Offshore Tax Evasion (June 17, 2009), www.oecd.org.

European Union is expending much energy in this direction as it works to create a single market. The EU's introduction of a single currency, the euro, highlights the tax disparities among its members.[6]

TAXATION OF FOREIGN-SOURCE INCOME AND DOUBLE TAXATION

Every nation claims the right to tax income originating within its borders. National philosophies regarding the taxation of foreign-source earnings differ, however, and this is important from a tax-planning perspective. A few countries, such as France, Hong Kong, Panama, and Venezuela, adopt the *territorial* principle of taxation and exempt from taxation the income of resident corporations generated outside their borders. This reflects the idea that tax burdens of foreign affiliates should equal those of their local competitors. In this view, foreign affiliates of local companies are viewed as foreign companies that happen to be owned by local residents.

Most countries (e.g., Australia, Brazil, China, the Czech Republic, Germany, Japan, Mexico, the Netherlands, the United Kingdom, and the United States) adopt the *worldwide* principle and tax resident corporations and citizens on income regardless of national boundaries. The underlying idea here is that a foreign subsidiary of a local company is simply a local company that happens to operate abroad.

Foreign Tax Credit

Under the worldwide principle of taxation, the foreign earnings of a domestic company are subject to the full tax levies of its host and home countries. To avoid discouraging businesses from expanding abroad, and in keeping with the concept of foreign neutrality, a parent company's domicile (country of residence) can elect to treat foreign taxes paid as a credit against the parent's domestic tax liability or as a deduction from taxable income. Companies generally choose the credit, because it yields a one-for-one reduction of domestic taxes payable (limited to the amount of income taxes actually paid),[7] whereas a deduction is only worth the product of the foreign tax expense multiplied by the domestic marginal tax rate.

Foreign tax credits may be calculated as a straightforward credit against income taxes paid on branch or subsidiary earnings and any taxes withheld at the source, such as dividends, interest, and royalties remitted to a domestic investor. The tax credit can also be estimated when the amount of foreign income tax paid is not clearly evident (e.g., when a foreign subsidiary remits a fraction of its foreign-source earnings to its domestic parent). Here, reported dividends on the parent company's tax return would be grossed up to include the amount of the tax (deemed paid) plus any applicable foreign withholding taxes. It is as if the domestic parent received a dividend including the tax due the foreign government and then paid the tax.

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[6] The EU focus is on harmonizing the corporate tax base rather than corporate tax rates. Under current proposals, companies would calculate one single, EU-wide income that would be divided among jurisdictions according to some rough measure of a firm's activities in each country. See "Harmony and Discord," *Economist* (May 5, 2007): 90–91.

[7] Indirect levies, such as foreign sales taxes, are generally not creditable.

The allowable foreign indirect tax credit (foreign income tax deemed paid) is determined as follows:

$$\frac{\text{Dividend payout (including any withholding tax)}}{\text{Earnings net of foreign income tax}} \times \text{Creditable foreign taxes}$$

To illustrate how foreign tax credits apply in a variety of situations, assume that a U.S. parent company receives royalties from Country A, foreign-branch earnings from Country B, and dividends from subsidiaries in Countries C and D. Withholding taxes on royalty and dividend payments are assumed to be 15 percent in Countries A, C, and D; income tax rates are assumed to be 30 percent in Country B and 40 percent in Country C. Country D assesses a 40 percent indirect sales tax as opposed to a direct tax on earnings within its jurisdiction.[8]

The key variables in this illustration, as shown in Exhibit 12-4, are the organizational form of the foreign activity (e.g., branch vs. subsidiary) and relative corporate income and withholding tax rates. In the first column, the royalty payment of $20.00 is subject to a 15 percent withholding tax in the host country (netting a $17.00 payment to the parent). For U.S. tax purposes, the net royalty is grossed up to include the withholding tax, which then forms the base for the U.S. domestic tax of 35 percent. The U.S. tax of $7.00 is offset by the credit for the foreign tax paid to yield a net U.S. tax liability of $4.00.

In the second column of Exhibit 12-4, the foreign branch earnings of the U.S. parent are grossed up to include foreign income taxes paid of $30.00. U.S. taxes payable on this amount of $35.00 are offset by a foreign tax credit of $30.00, to yield a net U.S. tax payable of $5.00. As with the royalty payment, the effect of the foreign tax credit is to limit the total tax on foreign-source income to the higher of the two countries' taxes. In this example, the U.S. tax rate of 35 percent was higher than the foreign tax rate of 30 percent, yielding a total tax on royalty and branch earnings of 35 percent.

Further scrutiny of Exhibit 12-4 is instructive. A comparison of columns 2 and 3 suggests the importance of organizational form on international taxes. A branch operation, viewed as an extension of the parent company, is subject to the full tax rate of the home country. In our example, the foreign branch pays a total tax of $35: $30 of foreign income taxes and $5 of U.S. taxes. Thus, the foreign branch bears the full burden of the U.S. income tax rate. However, it is spared any withholding taxes on earnings distributions to the parent because only a foreign subsidiary can distribute its earnings. On the other hand, a foreign operation organized as a subsidiary is taxed only on earnings that it remits to the parent company. It can defer taxes on retained income, and thus compete on an equal tax footing with local companies.

Columns 3 and 4 illustrate how a system of worldwide taxation places a subsidiary at a competitive disadvantage when it is located in a country that relies primarily on an indirect tax for revenue. Note that the subsidiary in Country D has a higher total tax burden because the tax credit only relieves direct taxes, not indirect taxes. Similarly, the benefits of tax incentives granted by host governments may also be nullified.

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[8] Note that royalty income and branch/subsidiary earnings are grossed up (i.e., included in U.S. income) before deducting foreign taxes paid.

EXHIBIT 12-4 U.S. Taxation of Foreign-Source Income

	Royalties from Operation in Country A	Earnings from Branch in Country B	Dividend from Subsidiary in Country C	Dividend from Subsidiary in Country D
Branch/Subsidiary				
Before-tax earnings		100.00	100.00	60.00
Foreign income taxes (30%/40%)		30.00	40.00	-0-
After-tax earnings		70.00	60.00	60.00
Dividend paid (50% of after-tax earnings)			30.00	30.00
Other foreign income	20.00			
Foreign withholding taxes (15%)	3.00		4.50	4.50
Net payment to parent	17.00		25.50	25.50
U.S. income	20.00	100.00[a]	30.00	30.00
Dividend gross-up (30/60 × 40)	____	____	20.00	-0-
Taxable income	20.00	100.00	50.00	30.00
U.S. tax (35%)	7.00	35.00	17.50	10.50
Foreign tax credit				
Paid	(3.00)	(30.00)	(4.50)	(4.50)
Deemed paid (30/60 × 40)	____	____	(20.00)	-0-
Total	(3.00)	(30.00)	(24.50)	(4.50)
U.S. tax (net)	4.00	5.00	(7.00)[b]	6.00
Foreign taxes	3.00	30.00	24.50	40.00[c]
Total taxes of U.S. taxpayer	7.00	35.00	17.50[d]	46.00

[a] *Grossed up to include foreign taxes actually paid.*

[b] *Excess foreign tax credits can be carried back one year or carried forward 10 years to offset U.S. tax on other foreign source (not U.S. source) income. If unavailable, total taxes = 24.50.*

[c] *40 percent indirect sales tax on 100.00.*

[d] *Excludes deferred tax on undistributed earnings of affiliate.*

Limits to Tax Credits

Home countries can tax foreign-source income in many ways. A country may elect to tax income from each separate national source. At the other extreme, all foreign-source income from any foreign source may be combined and taxed once. Some countries tax foreign-source income on a source-by-source basis, with the tax credit for foreign-source income limited to the corresponding domestic tax applicable to that income. As illustrated in columns 2 and 3 of Exhibit 12-4, the maximum tax liability will always be the higher of the tax rates in the host or home country. Other countries allow parent companies to pool income from many country sources by income type (e.g., dividends vs. interest vs. royalties). Excess tax credits from countries with high tax rates (column 3 of Exhibit 12-4) can offset taxes on income received from low-tax-rate countries (column 2 of Exhibit 12-4).

To prevent foreign tax credits from offsetting taxes on domestic-source income, many countries impose an overall limit on the amount of foreign taxes creditable in any year. The United States, for instance, limits the tax credit to the proportion of the U.S. tax that equals the ratio of the taxpayer's foreign-source taxable income to its worldwide taxable income for the year. Assume that Alpha Company earned $2,000 of foreign-source income and $3,000 of U.S.-source taxable income. Its foreign tax credit would be the lesser of the foreign income taxes paid or the foreign tax credit limitation computed as follows:

$$\text{Foreign tax credit limit} = \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}} \times \text{U.S. tax before credits}$$
$$= (\$2{,}000/\$5{,}000) \times (\$5{,}000 \times 35\%)$$
$$= \$700$$

Thus, only $700 would be allowed as a tax credit, even if foreign taxes paid exceeded $700. Excess foreign taxes paid can be carried back one year and forward 10 years (see footnote b in Exhibit 12-4).

A separate foreign tax credit limitation applies to U.S. taxes on the foreign-source taxable income of each of the following types of income (or *baskets*):

- Passive income (e.g., investment-type income, such as dividends, interest, royalties, and rents)
- General income (all other types)[9]

Foreign-source taxable income is foreign-source gross income less expenses, losses, and deductions allocable to the foreign-source income, plus a ratable share of expenses, losses, and deductions that cannot be allocated definitely to any item or class of gross income. The interpretation of this provision is reportedly one of the major areas of dispute between taxpayers and the IRS.[10]

Tax Treaties

Although foreign tax credits shield foreign-source income from double taxation (to some extent), tax treaties go further. Signatories to such treaties generally agree on how taxes and tax incentives will be imposed, honored, shared, or otherwise eliminated on business income earned in one taxing jurisdiction by citizens of another. Thus, most tax treaties between home and host countries provide that profits earned by a domestic enterprise in the host country shall be subject to its taxes only if the enterprise maintains a permanent establishment there. Tax treaties also affect withholding taxes on dividends, interest, and royalties paid by the enterprise of one country to foreign shareholders. They usually grant reciprocal reductions in withholding taxes on dividends and often entirely exempt royalties and interest from withholding.

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[9] Before the American Jobs Creation Act of 2004, excess taxes paid could be carried back two years and forward five years. The act also reduced the number of income baskets from nine to two. Both changes were designed to improve tax breaks for multinational corporations.

[10] P. Bodner, "International Taxation," in *International Accounting and Finance Handbook*, ed. Frederick D. S. Choi, 3rd ed. (New York: John Wiley, 2003), p. 30.11.

Foreign Exchange Considerations

The Tax Reform Act of 1986 introduced formal rules regarding the taxation of foreign currency gains or losses in the United States. In keeping with SFAS No. 52 (described in Chapter 6), all tax determinations must be made in the taxpayer's functional currency. The functional currency is assumed to be the U.S. dollar unless the foreign operation is an autonomous unit, or *qualified business unit.* In general, tax rules are similar but not necessarily identical to generally accepted accounting principles described in Chapter 6. Following are examples of tax treatments.[11]

Transaction gains or losses in currencies other than the functional currency are generally accounted for under the two-transactions perspective. Under this approach, any exchange gain or loss recognized when the foreign currency transaction is settled is treated as ordinary income and accounted for separately from the underlying transaction. However, gains or losses on transactions qualifying as hedges of certain foreign currency transactions can be integrated with the underlying transaction. For example, a gain or loss incurred on a forward exchange contract designated as an effective hedge of a foreign currency loan would offset the transaction gain or loss on the underlying obligation.

Foreign exchange gains or losses are generally allocated between U.S. and foreign sources by reference to the residence of the taxpayer on whose books the foreign currency asset or liability is reflected. Thus, for a U.S. corporation, the source of the gain or loss would be the United States.

Taxable profits for foreign branches are initially based on their functional currencies. The functional currency then is converted to U.S. dollars using the weighted average exchange rate for the taxable period. Foreign income taxes paid are translated at the exchange rate in effect when the tax is paid and then added to foreign taxable income or grossed up. The foreign taxes paid are then claimed as a foreign tax credit for U.S. tax purposes.

For foreign subsidiaries, deemed distributions under Subpart F regulations (discussed in the next section) are translated using weighted average exchange rates for the foreign corporation's taxable year. Deemed-paid foreign taxes are translated into U.S. dollars using exchange rates in effect on the date the tax was paid.

TAX-PLANNING DIMENSIONS

In tax planning, multinational companies have a distinct advantage over purely domestic companies because they have more geographical flexibility in locating their production and distribution systems. This flexibility provides unique opportunities to exploit differences among national tax jurisdictions so as to lower the overall tax burden for the corporation. The shifting of revenues and expenses through intracompany ties also gives MNCs additional opportunities to minimize the global taxes paid. In response, national governments are constantly designing legislation to minimize arbitrage opportunities involving different national tax jurisdictions.

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[11] Ibid., pp. 30.16–30.18.

We begin our examination of tax-planning issues with two caveats:

- Tax considerations should never control business strategy. The financial or operating strength of a business transaction must stand on its own.
- Constant changes in tax laws limit the benefits of long-term tax planning.

Organizational Considerations

In taxing foreign-source income, many taxing jurisdictions focus on the organizational form of a foreign operation. A branch is usually considered an extension of the parent company. Accordingly, its income is immediately consolidated with that of the parent (an option not available to a subsidiary) and fully taxed in the year earned whether remitted to the parent company or not. Earnings of a foreign subsidiary are not generally taxed until repatriated. Exceptions to this general rule are described in the next section.

If initial operations abroad are forecast to generate losses, it may be tax-advantageous to organize initially as a branch. Once foreign operations turn profitable, operating them as subsidiaries may be attractive. For one thing, the corporate overhead of the parent company cannot be allocated to a branch, because the branch is viewed as part of the parent. Moreover, if taxes on foreign profits are lower in the host country than in the parent country, profits of a subsidiary are not taxed by the parent country until repatriated (see columns 2 and 3 of Exhibit 12-4). If the subsidiary were organized in a tax-haven country that imposes no taxes at all, tax deferral would be even more attractive. National governments know this phenomenon, and many have taken steps to minimize corporate abuse of it. One example is the U.S. treatment of Subpart F income.

Controlled Foreign Corporations and Subpart F Income

Recall that in the United States, like many other countries adopting the worldwide principle of taxation, income of foreign subsidiaries is not taxable to the parent until it is repatriated as a dividend—the so-called deferral principle. Tax havens give multinationals an opportunity to avoid repatriation—and home-country taxes—by locating transactions and accumulating profits in "brass plate" subsidiaries. These transactions have no real work or employment attached to them. The income earned on these transactions is *passive* rather than *active.*

The United States closed this loophole with the Controlled Foreign Corporation (CFC) and Subpart F Income provisions.[12] A CFC is a corporation in which U.S. shareholders (U.S. corporations, citizens, or residents) directly or indirectly own more than 50 percent of its combined voting power or fair market value. Only shareholders holding more than a 10 percent voting interest are counted in determining the 50 percent requirement. Shareholders of a CFC are taxed on certain income of the CFC (referred to as *tainted* income) even before the income is distributed.

Subpart F income includes certain *related-party* sales and services income. For example, if a Bahamian subsidiary of a U.S. corporation "buys" inventory from its U.S. parent and sells the inventory to the European Union, the profits booked by the

[12] CFC legislation was first enacted in the United States in 1962. It has now been introduced in most industrialized countries as an anti–tax-haven measure.

Bahamian subsidiary are Subpart F income. On the other hand, if the Bahamian subsidiary sells the imported inventory in the Bahamas, income from the local sales is not Subpart F income. Subpart F income also includes passive income, such as dividends, interest, rents, and royalties; net gains on certain foreign exchange or commodities transactions; gains from the sale of certain investment property including securities; and certain insurance income.

Offshore Holding Companies

In some circumstances, a U.S.-based multinational parent company with operations in several foreign countries may find it advantageous to own its various foreign investments through a third-country holding company. The essential features of this structure are that the U.S. parent directly owns the shares of a holding company set up in one foreign jurisdiction, and the holding company, in turn, owns the shares of one or more operating subsidiaries set up in other foreign jurisdictions. The tax-related advantages of this holding company organizational form could include:

1. Securing beneficial withholding tax rates on dividends, interest, royalties, and similar payments
2. Deferring U.S. tax on foreign earnings until they are repatriated to the U.S. parent company (namely by reinvesting such earnings overseas)
3. Deferring U.S. tax on gains from the sale of the shares of the foreign operating subsidiaries

Realizing these advantages depends in large part on proper planning under complex U.S. tax rules (such as the Subpart F and foreign tax credit rules) and avoiding anti-treaty shopping rules found in many tax treaties.

Financing Decisions

The manner in which foreign operations are financed can also be shaped by tax considerations. Other things equal, the tax deductibility of debt, which increases the after-tax returns on equity, increases the attractiveness of debt financing in high-tax countries. Where local-currency borrowing is constrained by local governments that mandate minimum levels of equity infusion by the foreign parent, parent-company borrowing to finance this capital infusion could achieve similar ends, provided the taxing jurisdiction of the parent allows the interest to be deductible.

In other instances, offshore financing subsidiaries domiciled in a low-tax or tax-haven country also could be used as a financing vehicle. At one time, U.S. companies wishing to borrow funds in the eurodollar market were constrained from doing so because the U.S. government imposed a withholding tax on interest paid to foreign lenders. To lower the cost of financing, they formed offshore financing subsidiaries in the Netherlands Antilles, a country that has no withholding tax on interest to nonresidents.

In general, an offshore financing subsidiary, located in a low- or no-tax country, will issue securities and then lend money to an operating subsidiary (or the parent) located in a country with higher taxes. This intracompany loan results in interest income for the (low-/no-tax) financing subsidiary and deductible interest expense for the (higher tax) operating subsidiary. The result is higher after-tax consolidated profits.

Pooling of Tax Credits

We mentioned earlier that some countries limit tax credits on a source-by-source basis. Pooling income from many sources allows excess credits generated from countries with high tax rates to offset taxes on income received from low-tax jurisdictions. Excess tax credits, for example, can be extended to taxes paid in connection with dividends distributed by second- and third-tier foreign corporations in a multinational network. The United States allows this treatment provided that the U.S. parent's indirect ownership in such corporations exceeds 5 percent. Forward planning in the use of such credits can produce worthwhile tax benefits. Assume, for example, that a U.S. parent owns 100 percent of the shares of Company X (a first-tier foreign corporation). Company X owns 100 percent of the voting stock of Company Y (a second-tier foreign corporation). During the period, Company Y pays a dividend of 100 to Company X. Company X, in turn, remits a dividend of 100 to the U.S. parent as follows:

	U.S.Parent	Overseas Company X (First-tier Foreign Subsidiary)	Overseas Company Y (Second-tier Foreign Subsidiary)
1. Taxable earnings	100	200	200
2. Foreign income tax (15%/40%)		30	80
3. After-tax earnings		170	120
4. Dividends		100	100
5. Foreign taxes deemed paid	57	67	
	(100/170 × 97)	(100/120 × 80)	
6. Total taxes (2.+ 5.)		97	

Company X will be deemed to have paid 67 of the foreign income taxes paid by Company Y. In turn, the U.S. parent company will receive an indirect credit against U.S. taxes payable of 57 based on its share of taxes actually paid and deemed to have been paid by Company X (30 + 67). (Refer to our earlier discussion of the calculation of foreign credits.) In this illustration, a dividend from Company Y to Company X increases the allowable U.S. foreign tax credit attendant upon a dividend from Company X to the U.S. parent when the income taxes in Company Y's country of domicile exceed those in Company X's, and conversely.

Cost Accounting Allocations

Internal cost allocations among group companies are yet another vehicle to shift profits from high-tax to low-tax countries. The most common of these are allocations of corporate overhead expenses to affiliates in high-tax countries. The allocation of such service expenses as human resources, technology, and research and development will maximize tax deductions for affiliates in high-tax countries.

Location and Transfer Pricing

The locations of production and distribution systems also offer tax advantages. Thus, final sales of goods or services can be channeled through affiliates located in jurisdictions that offer tax shelter or deferral. Alternatively, a manufacturer in a high-tax country can obtain components from affiliates located in low-tax countries to minimize corporate taxes for the group as a whole. A necessary element of such a strategy is the prices at which goods and services are transferred between group companies. Profits for the corporate system as a whole can be increased by setting high *transfer prices* on components shipped from subsidiaries in relatively low-tax countries, and low transfer prices on components shipped from subsidiaries in relatively high-tax countries.

Transfer pricing has attracted increasing worldwide attention. The significance of the issue is obvious when we recognize that transfer pricing (1) is conducted on a relatively larger scale internationally than domestically, (2) is affected by more variables than are found in a strictly domestic setting, (3) varies from company to company, industry to industry, and country to country, and (4) affects social, economic, and political relationships in multinational business entities and, sometimes, entire countries. International transfer pricing is the most important international tax issue facing MNCs today.[13]

The impact of intracompany transfer pricing on international tax burdens cannot be examined in a vacuum; transfer prices can distort other parts of a multinational company's planning and control system. Cross-country transactions expose the multinational company to a host of strategic concerns that range from environmental risk to global competitiveness. These concerns often transcend tax considerations.

Integrating International Tax Planning

International tax planning should be integrally woven into corporate activities. Advises one tax attorney, "A tax plan should never be simply tacked on as an afterthought or bolted awkwardly on the side of a business or transaction."[14] To achieve integration of international tax planning, he recommends the following steps.

1. Seek competent tax advice in every relevant jurisdiction.
2. Communicate all the facts to each tax adviser. Tax conclusions are often based on fine distinctions among facts.
3. Appoint a single tax adviser to coordinate and reconcile the advice from the various jurisdictions.
4. Be sure that the plan fits the business. Sophisticated cross-border tax planning cannot be bought off-the-shelf.
5. Put all of the tax analysis in writing.
6. Be careful with the documentation of transactions. The audit battle is often won or lost based on the documents.
7. Obtain high-quality legal advice for any tax position that falls into a gray area or might be considered aggressive.
8. Consider how you would feel if your tax planning appeared in the local newspaper. If what you are doing might embarrass the company, don't do it.

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[13] Ernst & Young, *2005–2006 Global Transfer Pricing Surveys: Global Transfer Pricing Trends, Practices, and Analysis* (November 2005), p. 4 (www.ey.com).
[14] J. William Dantzler, Jr., as quoted in Fay Hansen, "Best Practices in Tax Planning," *Business Finance* (May 2004): 27.

Of these steps, 4 and 8 are the ones most frequently omitted, and the ones most likely to lead to trouble if they are not followed.[15]

INTERNATIONAL TRANSFER PRICING: COMPLICATING VARIABLES

The need for transfer pricing arises when goods or services are exchanged between organizational units of the same company. For example, it arises when one subsidiary of a corporation transfers inventory to another subsidiary or when the parent company charges a subsidiary for administrative and managerial services, royalties for intangibles rights, or interest on corporate-wide financing. The transfer price places a monetary value on intracompany exchanges that occur between operating units and is a substitute for a market price. It is generally recorded as revenue by one unit and a cost by the other.

Transfer pricing is of relatively recent origin. Transfer pricing in the United States developed along with the decentralization movement that influenced many American businesses during the first half of the 20th century. Once a company expands internationally, the transfer pricing problem quickly becomes more serious. It is estimated that 60 percent of all international trade consists of transfers between related business entities. Cross-country transactions also expose the multinational company to a host of environmental influences that both create and destroy opportunities to increase enterprise profits by transfer pricing. Such variables as taxes, tariffs, competition, inflation rates, currency values, restrictions on fund transfers, political risks, and the interests of joint-venture partners complicate transfer pricing decisions tremendously. On top of these issues, transfer pricing decisions generally involve many trade-offs, often unforeseen and unaccounted for.

Tax Considerations

Unless counteracted by law, corporate profits can be increased by setting transfer prices so as to move profits from subsidiaries domiciled in high-tax countries to subsidiaries domiciled in low-tax countries. As an example, Blu Jeans–Hong Kong, a wholly owned manufacturing subsidiary of Global Enterprises (USA), ships 500,000 pairs of designer blue jeans to a related U.S. sales affiliate, Blu Jeans–USA (also wholly owned by Global Enterprises), for $6 per pair. They cost Blu Jeans–Hong Kong $4.20 per pair to produce. Assuming that each garment wholesales for $12 in the United States, consolidated profits (after eliminating intercompany sales and costs) and taxes would total $1,309,000 and $591,000, respectively. This scenario is shown in Exhibit 12-5.

Given a U.S. corporate tax rate of 35 percent versus 16.5 percent in Hong Kong, an increase in the transfer price of blue jeans from $6 to $8 per pair would increase total after-tax income as shown in Exhibit 12-6.

In this example, raising the transfer price charged by the Hong Kong affiliate increases taxable income in Hong Kong and reduces taxable income for the U.S. affiliate by $1,000,000. Because the corporate tax rate is lower in Hong Kong than in the United States, corporate income taxes for the system as a whole decrease by $185,000, with a corresponding increase in consolidated after-tax earnings.

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[15] Ibid.

EXHIBIT 12-5 Tax Effects of Transfer Pricing

	Blu Jeans-HK	Blu Jeans-USA	Global Enterprises
Sales	$3,000,000[a]	$6,000,000	$6,000,000
Cost of sales	2,100,000	3,000,000[a]	2,100,000
Gross margin	$ 900,000	$3,000,000	$3,900,000
Operating expenses	500,000	1,500,000	2,000,000
Pretax income	$ 400,000	$1,500,000	$1,900,000
Income tax (16.5%/35%)[b]	66,000	525,000	591,000
Net income	$ 334,000	$ 975,000	$1,309,000

[a]*Based on a transfer price of $6 per unit.*

[b]*Income tax rates: Hong Kong 16.5 percent, United States 35 percent.*

EXHIBIT 12-6 Tax Effects of a Change in Transfer Prices

	Blu Jeans–HK	Blu Jeans–USA	Global Enterprises
Sales	$4,000,000[a]	$6,000,000	$6,000,000
Cost of sales	2,100,000	4,000,000[a]	2,100,000
Gross margin	$1,900,000	$2,000,000	$3,900,000
Operating expenses	500,000	1,500,000	2,000,000
Pretax income	$1,400,000	$ 500,000	$1,900,000
Income tax (16.5%/35%)	231,000	175,000	406,000
Net income	$1,169,000	$ 325,000	$1,494,000

[a]*Based on a transfer price of $8 per unit.*

Unfortunately, such actions often create unanticipated problems. Governments often counteract such measures. In the United States, Section 482 of the Internal Revenue Code gives the Internal Revenue Service authority to prevent a shifting of income or deductions between related taxpayers to exploit differences in national tax rates. The purpose of Section 482 is to ensure that taxpayers clearly reflect income attributable to *controlled transactions* (transactions between related taxpayers) and prevent the avoidance of taxes as a result of these transactions. The IRS is empowered to adjust income, deductions, credits, allowances, taxable basis, or any other item affecting taxable income if true taxable income has not been reported.

Section 482 essentially requires that intracompany transfers be based on an *arm's-length price.* An arm's-length price is one that an unrelated party would receive for the same or similar item under identical or similar circumstances. Acceptable arm's-length pricing methods include (1) comparable uncontrolled pricing, (2) resale pricing, (3) cost-plus pricing, and (4) other pricing methods. Severe penalties are imposed on valuation misstatements in connection with Section 482 adjustments. Penalties may be up to 40 percent of the additional taxes that result from income adjustments.

An emerging consensus among governments views arm's-length pricing as the appropriate standard in calculating profits for tax purposes. However, countries vary in

how they interpret and implement arm's-length pricing. As a result, it is a somewhat fluid concept internationally. Multinational corporations are often "caught in the middle" when tax authorities from different jurisdictions disagree on a transfer price, each trying to maintain its "fair share" of taxes collected from the multinational. The resulting controversy can be time-consuming and expensive to resolve. The rigor applied in monitoring the transfer pricing policies of multinational companies still varies worldwide. Nevertheless, tax authorities around the world are drafting new transfer pricing rules and stepping up enforcement efforts. In 1992, only Australia and the United States had documentation rules for multinationals' transfer pricing policies. Now, nearly 50 countries do. Audits are also being carried out with regularity, and a high percentage of completed audits are leading to transfer price adjustments. Whereas in the past many multinationals simply set transfer prices without further complications, now they have to justify them and document them, or run the risk of severe noncompliance penalties. Thus, transfer pricing has become a major compliance burden.

Transfer pricing schemes designed to minimize global taxes often distort the multinational control system. When each subsidiary is evaluated as a separate profit center, such pricing policies can result in misleading performance measures that generally lead to conflicts between subsidiary and enterprise goals. In our earlier example, Blu Jeans–USA would report a lower profit than its sister affiliate in Hong Kong, even though the management of the U.S. subsidiary may be far more productive and efficient than the management in Hong Kong.

Tariff Considerations

Tariffs on imported goods also affect the transfer pricing policies of multinational companies. For example, a company exporting goods to a subsidiary domiciled in a high-tariff country can reduce the tariff assessment by lowering the prices of merchandise sent there.

In addition to the trade-offs identified, the multinational company must consider additional costs and benefits, both external and internal. Externally, an MNC would have three taxing authorities to contend with: the customs officials of the importing country and the income tax administrators of the exporting and importing countries. A high tariff paid by the importer would result in a lower tax base for income taxes. Internally, the enterprise would have to evaluate the benefits of a lower (higher) income tax in the importing country against a higher (lower) import duty, as well as the potentially higher (lower) income tax paid by the company in the exporting country.

To illustrate, let us revisit our blue jeans example depicted in Exhibits 12-5 and 12-6. In our revised example (see Exhibit 12-7), assume that the United States imposes an ad valorem import duty of 10 percent. Under a low transfer pricing policy, lower import duties are paid ($300,000 vs. $400,000), but the import duty advantage of a low transfer price is offset by the increased income taxes that must be paid ($486,000 vs. $266,000). Considering both import duties and income taxes, Global Enterprises is still $120,000 better off under a high transfer pricing policy.

Competitive Factors

To facilitate the establishment of a foreign subsidiary abroad, a parent company could supply the subsidiary with inputs invoiced at very low prices. These price subsidies could be removed gradually as the foreign affiliate strengthens its position in the foreign

EXHIBIT 12-7 Trade-Offs When Tariffs and Income Taxes are Considered

	Blu Jeans–HK	Blu Jeans–USA	Global Enterprises
Low Transfer Price			
Sales	$3,000,000	$6,000,000	$6,000,000
Cost of sales	2,100,000	3,000,000	2,100,000
Import duty at 10%	—	300,000	300,000
Gross margin	900,000	$2,700,000	$3,600,000
Operating expenses	500,000	1,500,000	2,000,000
Pretax income	400,000	1,200,000	1,600,000
Income tax (16.5%/35%)	66,000	420,000	486,000
Net income	$ 334,000	$ 780,000	$1,114,000
High Transfer Price			
Sales	$4,000,000	$6,000,000	$6,000,000
Cost of sales	2,100,000	4,000,000	2,100,000
Import duty at 10%	—	400,000	400,000
Gross margin	1,900,000	$1,600,000	$3,500,000
Operating expenses	500,000	1,500,000	2,000,000
Pretax income	1,400,000	100,000	1,500,000
Income tax (16.5%/35%)	231,000	35,000	266,000
Net income	$1,169,000	$ 65,000	$1,234,000

market. Similarly, lower transfer prices could be used to shield an existing operation from the effects of increased foreign competition in the local market or another market; in other words, profits earned in one country could subsidize the penetration of another market. Indirect competitive effects are also possible. To improve a foreign subsidiary's access to local capital markets, setting low transfer prices on its inputs and high transfer prices on its outputs could bolster its reported earnings and financial position. Sometimes, transfer prices could be used to weaken a subsidiary's competitors.

Such competitive considerations would have to be balanced against many offsetting disadvantages. Transfer prices may, for competitive reasons, invite antitrust actions by host governments or retaliatory actions by local competitors. Internally, pricing subsidies do little to instill a competitive mode of thinking in the minds of the managers whose companies gain from the subsidy. What begins as a temporary aid may easily become a permanent management crutch.

Environmental Risks

Whereas competitive considerations abroad might warrant charging low transfer prices to foreign subsidiaries, the risks of severe price inflation might call for the opposite. Inflation erodes the purchasing power of a firm's cash. High transfer prices on goods or services provided to a subsidiary facing high inflation can remove as much cash from the subsidiary as possible.

Balance-of-payment problems (often related to inflation) may prompt foreign governments to devalue their currencies, impose foreign exchange controls, and/or impose

restrictions on the repatriation of profits from foreign-owned companies. Potential losses from exposures to currency devaluations may be avoided by shifting funds to the parent company (or related affiliates) through inflated transfer prices. With exchange controls (e.g., a government restricts the amount of foreign exchange available for importing a particular good), reduced transfer prices on the imported good would allow the affiliate affected by the controls to acquire more of the desired import. To circumvent repatriation restrictions, high transfer prices allow some cash to be returned to the parent company each time it sells a product or service to the foreign subsidiary.

Performance Evaluation Considerations

Transfer pricing policies are also affected by their impact on managerial behavior, and are often a major determinant of corporate performance. For example, if a foreign affiliate's mission is to furnish supplies for the rest of the corporate system, appropriate transfer prices enable corporate management to provide the affiliate with an earnings stream that can be used in performance comparisons. However, it is difficult for decentralized firms to set intracompany transfer prices that both (1) motivate managers to make decisions that maximize their unit's profits and are congruent with the goals of the company as whole, and (2) provide an equitable basis for judging the performance of managers and units of the firm. If subsidiaries are free to negotiate transfer prices, their managers may not be able to reconcile conflicts between what may be best for the subsidiary and what is best for the firm as a whole. However, the effect on subsidiary management may be even worse if corporate headquarters dictates transfer prices and sourcing alternatives that are seen as arbitrary or unreasonable. Moreover, the more decisions that are made by corporate headquarters, the less advantageous are decentralized profit centers, because local managers lose their incentive to act for the benefit of their local operations.

Resolving Trade-Offs

Management accountants can play a significant role in quantifying the trade-offs in transfer pricing strategy. The challenge is to keep a global perspective when mapping out the benefits and costs associated with a transfer pricing decision. The effects of the decision on the corporate system as a whole must come first.

Quantifying the numerous trade-offs is difficult because environmental influences must be considered as a group, not individually. Consider, for example, the difficulties in measuring the trade-offs surrounding transfer pricing policies for a subsidiary located in a country with high income taxes, high import tariffs, price controls, a thin capital market, chronic high inflation, foreign exchange controls, and an unstable government. As we have seen, a high transfer price on goods or services provided to the subsidiary would lower the subsidiary's income taxes and remove excess cash to the parent company. However, a high transfer price might also result in higher import duties, impair the subsidiary's competitive position (due to higher input prices), worsen the rate of inflation, raise the subsidiary's capital costs, and even cause retaliation by the host government to protect its balance-of-payments position. To further complicate matters, all of these variables are changing constantly. One thing is clear: Superficial calculations of the effects of transfer pricing policy on individual units within a multinational system are not acceptable.

TRANSFER PRICING METHODOLOGY

In a world of perfectly competitive markets, it would not be much of a problem to set prices for intracompany resource and service transfers. Transfer prices could be based either on incremental cost or on market prices. Neither system would necessarily conflict with the other. Unfortunately, there are seldom external competitive markets for products or services transferred between related entities. Environmental influences on transfer prices also raise questions of pricing methodology. How are transfer prices established? Are standard market prices generally better than those based on some measure of cost, or are negotiated prices the only feasible alternative? Can a single transfer pricing methodology serve all purposes equally well? The following sections shed some light on these questions.

Market vs. Cost vs. . . . ?

The use of market-oriented transfer prices offers several advantages. Market prices show the opportunity cost to the transferring entity of not selling on the external market, and their use will encourage the efficient use of the firm's scarce resources. Their use is also said to be consistent with a decentralized profit center orientation. Market prices help differentiate profitable from unprofitable operations, and are easier to defend to taxing authorities as arm's-length prices.

The advantages of market-based transfer prices must be weighed against several shortcomings. One is that using market prices does not give a firm much room to adjust prices for competitive or strategic purposes. A more fundamental problem is that there is often no intermediate market for the product or service in question. Multinationals engage in transactions that independent enterprises do not undertake, such as transferring a valuable, closely held technology to an affiliate. Transactional relationships among affiliates under common control often differ in important and fundamental ways from potentially comparable transactions among unrelated parties.

Cost-based transfer pricing systems overcome many of these limitations. Moreover, they are (1) simple to use, (2) based on readily available data, (3) easy to justify to tax authorities, and (4) easily routinized, thus helping to avoid internal frictions that often accompany more arbitrary systems.

Of course, cost-based transfer pricing systems are not flawless either. For example, the sale of goods or services at actual cost (or cost plus standard markup) may provide little incentive for sellers to control their costs. Production inefficiencies may simply be passed on to the buyer at inflated prices. Cost-based systems overemphasize historical costs, which ignore competitive demand-and-supply relationships, and do not allocate costs to particular products or services in a satisfactory manner. The problem of cost determination is compounded internationally because cost accounting concepts vary from country to country.

Arm's-Length Principle

The typical multinational is an integrated operation: Its subsidiaries are under common control and share common resources and goals. The need to declare taxable income in different countries means that multinationals must allocate revenues and expenses among subsidiaries and set transfer prices for intrafirm transactions.

Tax authorities around the world have developed complicated transfer-price and income allocation regulations as a part of their national income tax systems. Most are based on the *arm's-length principle*, which prices intrafirm transfers as if they took place between unrelated parties in competitive markets.[16] The OECD identifies several broad methods of ascertaining an arm's-length price. Resembling those specified by Section 482 of the U.S. Internal Revenue Code, they are (1) the comparable uncontrolled price method, (2) the comparable uncontrolled transaction method, (3) the resale price method, (4) the cost-plus method, (5) the comparable profit method, (6) the profit split method, and (7) other methods.

Comparable Uncontrolled Price Method

Under this approach, transfer prices are set by reference to prices used in comparable transactions between independent companies or between the corporation and an unrelated third party. It is appropriate when goods are sufficiently common that controlled sales are essentially comparable to sales on the open market. Commodity-type products ordinarily use this method for internal transactions.

Comparable Uncontrolled Transaction Method

This method applies to transfers of intangible assets. It identifies a benchmark royalty rate by referencing uncontrolled transactions in which the same or similar intangibles are transferred. Like the comparable uncontrolled price method, this method relies on market comparables.

Resale Price Method

This method calculates an arm's-length price by starting with the final selling price at which the item in question is sold to an uncontrolled third party. An appropriate margin to cover expenses and a normal profit is then deducted from this price to derive the intracompany transfer price. This method is typically used when the unit buying the item is a distributor or sales subsidiary.

To illustrate this pricing method, assume that a company wishes to price a product sold by one of its operating units to one of its foreign distribution units. Income statement accounts and other related facts for the distribution unit are as follows:

1. Net sales (by the distribution unit to third party) of 100,000 units at $300 per unit	$30,000,000
2. Other expenses (OE) of the distribution unit	1,200,000
3. OE as a percentage of net sales	4.0%
4. Freight and insurance to import (FI)	$1.50/unit
5. Packaging costs (PC)	$2.00/unit
6. Customs duties (CD)	5.0%
7. Net sales price (NSP) by the distribution unit	$300/unit

[16] Of course, the result is only hypothetical because the parties are related and the markets normally are not competitive. See L. Eden, M. T. Dacin, and W. P. Wan, "Standards Across Borders: Cross-border Diffusion of the Arm's-Length Standard in North America," *Accounting, Organizations and Society* (January 2001): 1–23.

The objective is to calculate a transfer price between the two units such that the distribution unit covers all costs and earns a normal profit. As we shall see, the resale price method is a *work backwards* approach. Assuming that the company requires a 5 percent additional margin to cover business risk and provide an appropriate profit, the total product margin would be computed as follows:

1. Other expenses	4.0%
2. Additional margin for risk and profit	5.0%
3. Total margin (TM)	9.0%

Here, the distribution unit must pay freight and insurance costs to import the product and customs duties in addition to the transfer price. (Thus, the distribution unit's cost to import differs from the transfer price.) Given the foregoing information, the transfer price (TP) per unit of product delivered to the distribution unit would be:

$$TP = \{[NSP \times (100\% - TM) - PC]/(100\% + CD)\} - FI$$
$$TP = \{[300 \times (100\% - 9\%) - \$2]/(100\% + 5\%)\} - \$1.50$$
$$TP = \$256.60$$

The foregoing calculation adjusts the net sales price for the total margin, packaging costs, freight and insurance costs, and customs duties to arrive at the transfer price. Specifically, the 1.05 factor adjusts the $271 cost-to-import price to a before-duties figure of $258.10. Other dutiable costs are subtracted from this figure to leave a transfer price of $256.60. The cost to import equals (1) the transfer price plus (2) freight and insurance, with duties applied to both. As a check on this result:

	Unit Cost
Transfer price	$256.60
+ Freight & Insurance	1.50
Subtotal	258.10
Duties (at 5%)	12.90
Cost to import	$271.00

To work backwards to the transfer price:

Net sales price	$300.00
Margin to cover expenses and normal profit (9%)	− 27.00
Packaging	− 2.00
Freight and insurance	− 1.50
Customs duties	− 12.90
Transfer price	$256.60

Cost-Plus Pricing Method

Cost-plus pricing is a *work forward* approach in which a markup is added to the transferring affiliate's cost in local currency. The markup typically includes (1) the imputed financing costs related to export inventories, receivables, and assets employed and

(2) a percentage of cost covering manufacturing, distribution, warehousing, internal shipping, and other costs related to export operations. An adjustment is often made to reflect any government subsidies that are designed to make manufacturing costs competitive in the international marketplace.

This pricing method is especially useful when semifinished goods are transferred between foreign affiliates, or where one entity is a subcontractor for another. A major measurement issue involves calculating the cost of the transferred item and ascertaining an appropriate markup.

To see how a transfer price is derived employing the cost-plus method, assume that a manufacturing unit in Portugal wishes to price an intracompany transfer based on the following information:

1. Total manufacturing cost per unit (1,000 units)	€ 200
2. Average net operating assets employed in manufacturing the item	€ 40,000
3. Average short-term interest rate in Portugal	8.0%
4. Financing cost as a percentage of total manufacturing cost [(8% × Euro 40,000)/Euro 200,000]	1.6%
5. Government subsidy based on final transfer price	6.0%
6. Credit terms to affiliates	90 days
7. Required profit and other expenses margin	8.0%

The cost-plus transfer price is that price which enables the transferring unit to earn a given percentage return above its production costs. That percentage return (the *plus* in cost-plus) is determined in the following manner:

1. Required margin before adjustments:		
Profit and other expenses	8.0%	
Financing cost	1.6%	9.60%
2. Government subsidy adjustment		6.00%
3. Adjusted margin with cash terms [(1.096/1.06) – 1]		3.39%
4. Adjusted margin with 90-day terms		5.46%[a]

[a] *This figure is equal to the adjusted margin-cash terms multiplied by 1 plus the short-term interest rate for 90 days, or {1 .0339 × [1 + (0.08 × 90/360)]} − 1. It allows the transferring unit to earn imputed interest for carrying a receivable for 90 days.*

This required margin of 5.46 percent, when multiplied by the transferred item's total manufacturing cost, yields the intracompany transfer price to be billed for that item. In this example, the transfer price is € 210.92, the result of (1.0546 × € 200). This transfer price causes the company to earn its required margin of 9.6 percent and an 8 percent (annualized compounded) return for carrying the affiliate's receivable for 90 days. As a check on this result:

$$\text{Compounded return} = \{1.096 \times [1 + (.08 \times 90/360)]\} - 1$$
$$= 11.79\%$$

Transfer price	=	€210.92
Cost		200.00
Margin		€ 10.92
Subsidy (6% × 210.92)		12.66
Total return		€ 23.58

Return as a % of cost = (€23.58)/(€200.00) = 11.79%

Comparable Profits Method

The comparable profits method supports the general notion that similarly situated taxpayers should earn similar returns over reasonable time periods.[17] Thus, intracompany profits on transactions between related parties should be comparable to profits on transactions between unrelated parties who engage in similar business activities under similar circumstances. *Return on capital employed* (ROCE) is a primary profit-level indicator. Under this approach, the operating income to average capital employed ratio of a benchmark entity is compared with the ROCE of the entity in question.

Application of this method will normally require adjustments for any differences between comparables. Factors requiring such adjustments include differing sales conditions, cost of capital differences, foreign exchange and other risks, and differences in accounting measurement practices.

Profit-Split Methods

Profit-split methods are used when product or market benchmarks are not available. Essentially they involve dividing profits generated in a related-party transaction between the affiliated companies in an arm's-length fashion. One variant of this approach, the *comparables profit-split method*, divides the profit generated by a related-party transaction using a percentage allocation of the combined profits of uncontrolled companies with similar types of transactions and activities.

A more sophisticated method, the *residual profit-split method*, employs a two-step approach. First, routine functions performed by affiliated entities—the parent and its subsidiary—are priced at each stage of the production process using relevant benchmarks. Any difference between total profits earned by the combined enterprise and those attributable to the routine functions is considered *residual profits*, essentially profits from nonroutine functions. This residual, which resembles a goodwill intangible, then is split on the basis of the relative value of each affiliated party's contribution to the intangible. This value can be determined using fair market value referents or the capitalized cost of developing the intangibles.

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[17] The comparable profits method is similar to the transactional net margin method (TNMM) in the OECD guidelines. The key difference is that TNMM is applied on a transactional rather than a firm level. For more information on this and the profit-split method, see Victor H. Miesel, Harlow H. Higinbotham, and Chun W. Yi, "International Transfer Pricing: Practical Solutions for Intercompany Pricing: Part II," *International Tax Journal* (winter 2003): 1–40.

Other Pricing Methods

As existing pricing methodologies do not always reflect underlying circumstances, additional methodologies are allowed if they result in a more accurate measure of an arm's-length price. To quote the OECD:

> It has to be recognized that an arm's-length price will in many cases not be precisely ascertainable and that in such circumstances it will be necessary to seek a reasonable approximation to it. Frequently, it may be useful to take account of more than one method of reaching a satisfactory approximation to an arm's-length price in the light of the evidence available.[18]

Section 482 of the U.S. Internal Revenue Code specifies a *best methods rule* requiring the taxpayer to select the best transfer pricing method based on the facts and circumstances of the case. Argentina and Taiwan also have a best methods rule. Most countries with transfer pricing legislation prefer transaction-based methods (comparable uncontrolled price, comparable uncontrolled transaction, resale price, and cost-plus methods) to profit-based methods (comparable profit and profit-split methods). These countries include Belgium, Germany, Japan, the Netherlands, and the United Kingdom.[19] OECD guidelines specify that a *reasonable* method should be chosen, and also prefer transaction-based methods to profit-based methods.

It is not always possible to calculate a precise and accurate arm's-length price. Hence, documentation of any transfer price employed and its underlying rationale is important. This is true regardless of the tax jurisdiction and the transfer pricing methods it may prefer. An increasing number of countries now require companies to keep documentation substantiating the transfer pricing method(s) used for intracompany transactions. The following steps are helpful in justifying transfer prices:

- Analyze the risks assumed, functions performed by the affiliated companies, and the economic and legal determinants that affect pricing.
- Identify and analyze benchmark companies and transactions. Document reasons for any adjustments made.
- Compare the financial results of the comparable companies and the taxpayer.
- If comparable transactions are available, note their similarities and differences with the taxpayer's transactions.
- Document why the chosen pricing method is the most reasonable and why the other methods are not.
- Update the information before filing the tax return.[20]

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[18] Organization for Economic Cooperation and Development, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), p. 33.

[19] Deloitte, *Strategy Matrix for Global Transfer Pricing: Planning Methods, Documentation, Penalties and Other Issues* (2006), pp. 10–11 (www.deloitte.com).

[20] Alan Shapiro and Arnold McClellan, "New Transfer Pricing: New Rules Give Guidance on How to Avoid Penalties," *Deloitte Touche Tohmatsu International World Tax News* (March 1994): 2. For further information on transfer pricing documentation, see Cym H. Lowell, Mark R. Martin, and Michael J. Donahue, "Managing Transfer Pricing, Part I," *Journal of International Taxation* (July 2006): 44–58.

Advance Pricing Agreements

The acceptability of transfer prices to governments is a major concern. Aware that multinational enterprises use transfer prices to shift income, and worried about their economic and social consequences, governments are increasing their scrutiny of multinational operations. At the same time, the ambiguities and complexities of transfer pricing regulations make it likely that intracompany transactions will be the target of tax audits. Surveys of multinationals consistently show that they regard transfer pricing as their most important international tax issue and that facing a transfer pricing audit somewhere in the world is a near certainty.[21]

Advance pricing agreements (APAs) are a mechanism whereby a multinational and a taxing authority voluntarily negotiate an agreed transfer pricing methodology that is binding on both parties. These agreements reduce or eliminate the risk of a transfer pricing audit, saving time and money for both the multinational and the taxing authority. Multinationals are increasingly using APAs as a controversy-management tool. Introduced in the United States in 1991, APAs have been widely adopted by other countries.[22] The agreements are binding for a fixed period of time; for example, three years in the United States.

Exhibit 12-8 summarizes the transfer pricing requirements in the 10 countries discussed in Chapters 3 and 4.

EXHIBIT 12-8 Transfer Pricing Requirements in Selected Countries

	Preference for Transfer Pricing Method	Statutory Requirements for Transfer Pricing Documentation[a]	Availability of APA
China	Best method	Yes	Yes
Czech Republic	Transaction-based	Yes	Yes
France	Transaction-based	No	Yes
Germany	Transaction-based	Yes	Yes
India	Best method	Yes	No
Japan	Transaction-based	No	Yes
Mexico	Transaction-based	Yes	Yes
Netherlands	No preference	Yes	Yes
United Kingdom	Transaction-based	Yes	Yes
United States	Best method	No	Yes

Sources: Compiled from Ernst & Young, *2005–2006 Global Transfer Pricing Surveys—Tax Authority Interviews: Perspectives, Interpretations, and Regulatory Changes* (2006), www.ey.com; Deloitte, *Strategy Matrix for Global Transfer Pricing* (2008), www.deloitte.com; Ernst & Young, *Transfer Pricing Global Reference Guide* (2008), www.ey.com.

[a]*Countries with no statutory requirements for maintaining transfer pricing documentation will require companies to produce documentation upon request, normally at the time of an audit. For example, taxpayers must produce such documentation within 30 days of the request in the United States and within 60 days in France. Given that a significant amount of documentation will need to be provided, companies are well advised to maintain the documentation in any event.*

[21] Ernst & Young, *Transfer Pricing 2003 Global Survey* (2003): 10–15 (www.ey.com) and PriceWaterhouseCoopers, *Transfer Pricing Perspectives: The Emerging Perfect Storm of Transfer Pricing Audits and Disputes* (2008), (www.pwc.com).

[22] APAs go by different names. For example, they are called advance pricing arrangements in the United Kingdom and preconfirmation systems in Japan. The U.S. APA program is the largest such program in the world.

TRANSFER PRICING PRACTICES

Multinational corporations obviously vary along many dimensions, such as size, industry, nationality, organizational structure, degree of international involvement, technology, products or services, and competitive conditions. Therefore, it is hardly surprising that a variety of transfer pricing methods are found in practice.[23] Most of the empirical evidence on transfer pricing practices is based on surveys. Because corporate pricing policies are often considered proprietary, such surveys should be interpreted cautiously. Given the dramatic effect of globalization on business operations since the 1990s, we are also cautious about whether early transfer pricing surveys are still valid today.[24]

What factors influence the choice of transfer pricing methods? Are transfer pricing effects considered in the planning process? One study from the 1990s asked financial executives of U.S. multinationals to identify the three most important objectives of international transfer pricing.[25] Managing the tax burden dominated the other objectives, but operational uses of transfer pricing, such as maintaining the company's competitive position, promoting equitable performance evaluation, and motivating employees, were also important. Managing inflation, managing foreign exchange risk, and mitigating restrictions on cash transfers were relatively unimportant.

Another study asked a similar question of managers of multinationals from 19 nations.[26] In their responses, operational issues had a slightly higher priority than tax issues. The study also found that the operational and tax effects of transfer pricing are most often considered only after the strategic decisions have been made. However, a subsequent survey indicated that transfer pricing now plays a more important role in the multinational planning process.[27] The multinational corporations surveyed indicate that significantly more of them consider tax issues earlier in the business planning cycle than they did five years earlier. Transfer pricing is increasingly perceived as less of a compliance issue and more of a planning issue that contributes value.

THE FUTURE

Technology and the global economy are challenging many of the principles on which international taxation is based. One of these principles is that every nation has the right to decide for itself how much tax to collect from the people and businesses within its

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[23] Most multinationals use more than one method, depending on the circumstances.

[24] For example, one widely cited study [J. S. Arpan, "International Intracorporate Pricing: Non-American Systems and Views," *Journal of International Business Studies* (spring 1972): 1–18] found that U.S., French, British, and Japanese managers prefer cost-oriented transfer pricing methods, whereas Canadian, Italian, and Scandinavian managers prefer market-oriented methods; no particular preference was found for Belgian, Dutch, German, or Swiss managers. While we believe that nationality continues to influence the choice of transfer pricing methods, we question whether this particular conclusion is still valid.

[25] K. S. Cravens, "Examining the Role of Transfer Pricing as a Strategy of Multinational Firms," *International Business Review* 6, no. 2 (1997): 127–145.

[26] Ernst & Young, "1999 Global Transfer Pricing Survey," reprinted in R. Feinschrieber, *Transfer Pricing International: A Country-by-Country Comparison* (New York: John Wiley, 2000), pp. 35.1–35.49.

[27] Ernst & Young, *2005–2006 Global Transfer Pricing Surveys: Global Transfer Pricing Trends, Practices, and Analysis*, November 2005, p. 15 (www.ey.com). See also Ernst & Young, *Precision Under Pressure: Global Transfer Pricing Survey 2007–2008*, 2008 (www.ey.com).

borders. Tax laws evolved in a world where transactions took place in clearly identifiable locations, but this is increasingly less true. Electronic commerce over the Internet ignores borders and physical location. Commercial events now take place in cyberspace—on a server anywhere in the world.[28]

The ability to collect taxes depends on knowing who should pay, but increasingly sophisticated encryption techniques make it harder to identify taxpayers. Anonymous electronic money is a reality. The Internet also makes it easy for multinationals to shift their activities to low-tax countries that may be a long way from customers but as close as a mouse click to access. It is becoming more difficult to monitor and tax international transactions. Further, there is a growing unease among governments that they are losing their grip on companies that increasingly can and do move their employees, know-how, capital, headquarters—and taxable profits—overseas.

Governments around the world require transfer pricing methods based on the arm's-length principle. That is, a multinational's businesses in different countries are taxed as if they were independent firms operating at arm's-length from each other. The complex calculation of arm's-length prices is less relevant today for global companies because fewer of them operate this way. Many multinationals now have global brands, global research and development, and regional profit centers. It is difficult to say exactly where their profits are generated. Moreover, companies are increasingly service-oriented and rely on brand names, intellectual property, and intangibles that are hard to price.[29]

What do these developments imply for international taxation? Are national taxes compatible with a global economy? We already see greater cooperation and information sharing by tax authorities around the world. This trend will continue. At the same time, many experts foresee greater tax competition. The Internet makes it easier to take advantage of tax havens. Some observers advocate a *unitary tax* as an alternative to using transfer prices to determine taxable income. Under this approach, a multinational's global profit is allocated to individual countries based on a formula that reflects the company's relative economic presence in the country. Each country would then tax its piece of the profit at whatever rate it sees fit. Clearly, taxation in the future faces many changes and challenges.[30]

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[28] The digitization of tangible products is an example. A compact disc bought at a record store is a tangible item purchased at a physical location. Taxing this transaction is fairly simple because it is easy to identify the source of income. If it is downloaded online, it is an intangible purchased in cyberspace. Who can tax this transaction, and how, is less clear.

[29] The 2006 transfer pricing settlement between the pharmaceutical company GlaxoSmithKline and the U.S. Internal Revenue Service involved such issues. The settlement was the largest tax dispute in the history of the IRS. GlaxoSmithKline agreed to pay the IRS $3.4 billion.

[30] See "The Mystery of the Vanishing Taxpayer: A Survey of Globalisation and Tax," *Economist* (January 29, 2000): 1–22; S. James, "The Future International Tax Environment," *International Tax Journal* (winter 1999): 1–9; N. Warren, "Internet Challenges to Tax System Design," in *The International Taxation System*, ed. A. Lymer and J. Hasseldine (Boston: Kluwer Academic Publishers, 2002), pp. 61–82; "A Taxing Battle," *Economist* (January 31, 2004): 71–72.

Discussion Questions

1. What is tax neutrality? Are taxes neutral with regard to business decisions? Is this good or bad?
2. What philosophies and types of taxes exist worldwide?
3. Consider the statement "National differences in statutory tax rates are the most obvious and yet least significant determinants of a company's effective tax burden." Do you agree? Explain.
4. Carried to its logical extreme, tax planning implies a conscientious policy of tax minimization. This mode of thinking raises an ethical question for international tax executives. Deliberate tax evasion is commonplace in many parts of the world. In Italy, for example, tax legislation is often honored only in the breach. Even when tax laws are enforced, actual tax settlements are usually subject to negotiation between the taxpayer and the tax collector. Should multinational corporations operating in such environments adopt a policy of "When in Rome do as the Romans do?" or should they adhere to the taxation norms of their domestic environments?
5. Compare and contrast the role of transfer pricing in national versus international operations.
6. Multinational transfer pricing causes serious concern for various corporate stakeholders. Identify potential concerns from the viewpoint of
   a. minority owners of a foreign affiliate,
   b. foreign taxing authorities,
   c. home-country taxing authorities,
   d. foreign-subsidiary managers, and
   e. headquarters managers.
7. The pricing of intracompany transfers is complicated by many economic, environmental, and organizational considerations. Identify six major considerations described in the chapter and briefly explain how they affect transfer pricing policy.
8. Identify the major bases for pricing intercompany transfers. Comment briefly on their relative merits. Which measurement method is best from the viewpoint of the multinational executive?
9. Explain the arm's-length price. Is the U.S. Internal Revenue Service alone in mandating such pricing of intracompany transfers? Would the concept of an arm's-length price resolve the measurement issue in pricing intracompany transfers?
10. What is an advance pricing agreement (APA)? What are the advantages and disadvantages of entering into an APA?

Exercises

1. A Chinese manufacturing subsidiary produces items sold in Australia. The items cost the equivalent of $7.00 to produce and are sold to customers for $9.50. A Cayman Islands subsidiary buys the items from the Chinese subsidiary for $7.00 and sells them to the Australian parent for $9.50.

   Required: Calculate the total amount of income taxes paid on these transactions. What are the implications for the company and the taxing authorities involved?
2. Kowloon Trading Company, a wholly owned subsidiary incorporated in Hong Kong, imports macadamia nuts from its parent company in Honolulu for export to various duty-free shops in the Far East. During the current fiscal year, the company imported $2,000,000 worth of nuts and retailed them for $6,000,000. Local income taxes are paid at the rate of 16.5 percent. Profits earned by the Hong Kong subsidiary are retained for future expansion.

   Required: Based on this information, calculate the U.S. parent company's U.S. tax liability under Subpart F provisions of the Internal Revenue Code.
3. A jewelry manufacturer domiciled in Amsterdam purchases gold from a precious metals dealer in Belgium for €2,400. The manufacturer

fabricates the raw material into an item of jewelry and wholesales it to a Dutch retailer for €4,000.

Required: Compute the value-added tax from the jewelry manufacturer's activities if the Dutch value-added tax rate is 17.5 percent.

4. Sweden has a classical system of taxation. Calculate the total taxes that would be paid by a company headquartered in Stockholm that earns 1,500,000 Swedish krona (SEK) and distributes 50 percent of its earnings as a dividend to its shareholders. Assume that the company's shareholders are in the 40 percent tax bracket and that the company's income tax rate is 28 percent.
5. Alubar, a U.S. multinational, receives royalties from Country A, foreign-branch earnings from Country B, and dividends equal to 50 percent of net income from subsidiaries in Countries C and D. There is a 10 percent withholding tax on the royalty from Country A and a 10 percent withholding tax on the dividend from Country C. Income tax rates are 20 percent in Country B and 40 percent in Country C. Country D assesses indirect taxes of 40 percent instead of direct taxes on income. Selected data are as follows:

	Country A	Country B	Country C	Country D
Royalty from Country A operations	$20			
Pretax income		$90	$90	$54
Income taxes (20%/40%)		18	36	-0-
Net income		$72	$54	$54

Required: Calculate the foreign and U.S. taxes paid on each foreign-source income.

6. Global Enterprises has a manufacturing affiliate in Country A that incurs costs of $600,000 for goods that it sells to its sales affiliate in Country B. The sales affiliate resells these goods to final consumers for $1,700,000. Both affiliates incur operating expenses of $100,000 each. Countries A and B levy a corporate income tax of 35 percent on taxable income in their jurisdictions.

   Required: If Global Enterprises raises the aggregate transfer price such that shipments from its manufacturing to its sales affiliate increase from $1,000,000 to $1,200,000, what effect would this have on consolidated taxes?
7. Using the facts stated in Exercise 6, what would be the tax effects of the transfer pricing action if corporate income tax rates were 30 percent in Country A and 40 percent in Country B?
8. Drawing on the background facts in Exercises 6 and 7, assume that the manufacturing cost per unit, based on operations at full capacity of 10,000 units, is $60, and that the uncontrolled selling price of the unit in Country A is $120. Costs to transport the goods to the distribution affiliate in Country B are $16 per unit, and a reasonable profit margin on such cross-border sales is 20 percent of cost.
   Now suppose that Country B levies a corporate income tax of 40 percent on taxable income (vs. 30 percent in Country A) and a tariff of 20 percent on the declared value of the imported goods. The minimum declared value legally allowed in Country B is $100 per unit with no upper limit. Import duties are deductible for income tax purposes in Country B.

   Required:
   a. Based on the foregoing information, formulate a transfer pricing strategy that would minimize Global Enterprise's overall tax burden.
   b. What issues does your pricing decision raise?
9. Lumet Corporation, a manufacturer of cellular telephones, wishes to invoice a sales affiliate located in Fontainebleau for an order of 10,000 units. Wanting to minimize its exchange risk, it invoices all intracompany transactions in euros. Relevant facts on a per unit basis are as follows: net sales price, €450; other operating expenses, €63; freight and insurance, €1; packaging costs, €1.50. Customs duties are 5 percent, and Lumet Corporation wishes to earn a profit of 6 percent on the transaction.

Required: Determine the price at which Lumet would invoice its French affiliate for the cellular phones.

10. The partial income statement of the Lund Manufacturing Company, a Swedish-based concern producing pharmaceutical products, is presented below:

During the year, short-term interest rates in Sweden averaged 7 percent, while net operating assets averaged SEK 45,000,000. The company is entitled to a government subsidy of 5 percent. Its required margin to provide a profit and cover other expenses is 8 percent. All affiliates receive credit terms of 60 days.

Required: Based on this information, at what price would the Lund Manufacturing Company invoice its distribution affiliate in neighboring Finland?

Sales	SEK 75,000,000
Cost of goods manufactured and sold:	
Finished goods, beginning inventory	-0-
Cost of goods manufactured: (100,000 units)	
Direct materials used	SEK 22,500,000
Direct labor	11,600,000
Overhead	6,000,000
Cost of goods available for sale	40,100,000
Finished goods, ending inventory	8,000,000
Cost of goods sold	32,100,000
Gross Margin	SEK 42,900,000

CASES

Case 12-1

The Shirts Off Their Backs

Do accountants share the blame for Third World poverty? A report by the U.K.-based Christian Aid says so.[31] It attacks accounting firms for helping to perpetuate poverty in the developing world through their aggressive marketing of tax-avoidance schemes: "The tax avoidance industry [including accounting firms] has a very negative impact on developing countries and their ability to raise taxation—which is . . . critical for their escape from poverty."[32]

According to the report, the debate over how poor countries fund their escape from poverty has up to this point focused mainly on calls for debt cancellation and increases in aid.[33] While these factors are important, they are only pieces in a larger and more complicated puzzle. Solving this puzzle involves looking not only at the money that flows into poor countries, but also at money they can't get their hands on and the money that leaks away.

Taxation is facing a crisis in poorer countries. In the rich world, government revenue from taxation between 1990 and 2000 averaged 30 percent of gross domestic product (GDP). In sub-Saharan Africa, the average over the same period was 17.9 percent, in Latin America it was 15.1 percent, and in south Asia it was 10.5 percent. The low tax yield in poorer regions of the world limits the amount of domestically generated resources that are available to governments for essential public services, such as healthcare and education.

To quote the report:

> It is not by accident that poor countries have been unable to increase the amount of revenue they raise through taxation. There are three specific tax strategies that have hindered them:
>
> 1. ***Tax competition*** between countries means poorer nations have been forced to lower corporate tax rates, often dramatically, in order to attract foreign investment.
> 2. ***Trade liberalization*** has deprived poorer countries of taxes on imports. In some cases, these had yielded up to one-third of their tax revenue.
> 3. ***Tolerance of tax havens*** has helped wealthy individuals and multinational companies (as well as criminals, corrupt leaders and terrorists) move their wealth and profits offshore to avoid paying taxes.[34]

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[31] Christian Aid, *The Shirts Off Their Backs: How Tax Policies Fleece the Poor* (September 2005), www.christianaid.org.uk.
[32] Andrew Pendleton, Christian Aid's senior policy officer, as quoted in Alice Nation, "Christian Aid Attacks Accountants over Tax Avoidance Schemes," *Accountancy* (October 2005): 11.
[33] Aid from the rich world is volatile and sometimes comes with strings attached.
[34] Christian Aid, *The Shirts Off Their Backs: How Tax Policies Fleece the Poor* (September 2005): 4 (www.christianaid.org.uk).

Tax havens affect developing countries in a number of ways:

- Secret bank accounts and offshore trusts encourage wealthy individuals and companies to escape paying taxes by providing a place for untaxed earnings and profits to be banked.
- Many multinational corporations launder profits earned in developing countries by importing goods at hugely inflated prices and exporting commodities at a fraction of their true value.[35] They do this through paper subsidiaries in tax havens, providing them with a significant tax advantage over their nationally based competitors and fleecing governments of tax revenue.
- Banking secrecy and trust services provided by globalized financial institutions operating offshore provide a secure cover for laundering the proceeds of political corruption, fraud, embezzlement, illicit arms trading, and the global drugs trade.[36]

Who is to blame for this crisis? The study points the finger at international institutions like the International Monetary Fund and the World Bank, multinational corporations, banks, and accountants.

Accountancy firms . . . are champions of 'tax planning' whereby, along with their clients they organize networks of offshore subsidiaries to avoid paying tax. The collapse of Enron provided a rare insight into precisely how this works. The U.S. Senate report into the Enron case shows how accountants Andersen facilitated Enron's massive tax avoidance. The company paid no tax at all between 1995 and 1999.[37] Tax planning by accountants made this possible and involved setting up a global network of 3,500 companies, more than 440 of which were in the Cayman Islands. The subsequent Sarbanes-Oxley legislation in the United States is intended to act as a deterrent, by making directors and shareholders more responsible for the consequences of such strategies. But it does little to lift the veil of secrecy surrounding tax havens.[38]

Required

1. Why should wealthy nations be concerned about seeing that poor ones collect their "fair share" of taxes?
2. Do you agree that accountants and accounting firms share the blame for perpetuating poverty in the developing world? Why or why not?
3. Is tax planning wrong?
4. Assume that you agree that new policies are needed to improve the ability of Third World countries to increase their tax yields. List policy recommendations that will achieve this result, and explain why you think these policies are needed.

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[35] The report cites data that 45 to 50 percent of intracompany transfers are mispriced in Latin America and 60 percent are mispriced in Africa.
[36] Christian Aid, *The Shirts Off Their Backs: How Tax Policies Fleece the Poor* (September 2005): 11–12 (www.christianaid.org.uk).
[37] According to a 2004 U.S. Government Accountability Office report, 60 percent of U.S. corporations with at least $450 million in assets reported no federal tax liability for any of the years between 1996 and 2000.
[38] Christian Aid, *The Shirts Off Their Backs: How Tax Policies Fleece the Poor* (September 2005): 17 (www.christianaid.org.uk).

Case 12-2

Muscle Max: Your Very Own Personal Trainer

Muscle Max–Asia, a wholly owned affiliate of a French parent company, functions as a regional headquarters for operating activities in the Pacific Rim. It enjoys great autonomy from its French parent in conducting its primary line of business, the manufacture and sale of Muscle Max, a commercial-grade weight-lifting machine that can be used in athletic clubs or in the home. Muscle Max–Asia has manufacturing affiliates in Malaysia and Canton (China) and distribution outlets in Australia, Japan, New Zealand, South Korea, and Singapore. It plans to expand its operations to other Pacific Rim countries in the next several years.

Given the demand for weight-lifting equipment in Australia, the company's distribution affiliate there, Muscle Max–Australia, has been importing its equipment from both Canton and Malaysia, paying a customs duty of 5 percent. Competing suppliers of similar equipment have approached the Australian affiliate for orders. Prices quoted on such machinery have ranged between 650 to 750 Australian dollars (A$). Muscle Max–Australia, which currently retails the machine for A$1,349, recently complained to Muscle Max–Asia because of the differences in the prices it is being charged by its sister affiliates in Canton and Malaysia. Specifically, while the Malaysian affiliate charges a per unit price of A$675, the Canton supplier's price is 26 percent higher. Muscle Max–Asia explains that the transfer price, based on a cost-plus formula (production costs total A$540 per unit), reflects several considerations, including higher margins to compensate for credit risk, operating risk, and taxes. As for taxes, Muscle Max–Asia explains that the People's Republic of China provides fiscal incentives to enterprises that promote exports. Although normal corporate income tax rates are 33 percent, Cantonese tax authorities have agreed to a rate of 10 percent on all export-related earnings.

The manager of Muscle Max–Australia remains skeptical and believes that he is paying for the Cantonese manager's inefficiency. In his latest communication, he asks if he can consider alternative suppliers of weight-lifting equipment to preserve local market share.

Required

1. What issues does this case raise?
2. What courses of action would you recommend to resolve the issues you have identified?