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Transfer pricing practices of transnational corporations in PATA countries

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ABSTRACT

The tax authorities of Australia, Canada, Japan and the United States formed the Pacific Association of Tax Administrators (PATA) in 1980 to combat income shifting, improve cross-border information flows, and develop conciliatory relationships among themselves. One of their specific concerns was to identify and stop the improper transfer pricing used by transnational corporations (TNCs) to facilitate income shifting and obfuscation of financial data.

The purpose of this study is to determine: (1) what PATA membership means for TNCs, and (2) whether or not transfer pricing audits have increased due to information sharing or decreased due to PATA's various transfer pricing guides. A survey of tax executives in Australian, Canadian, Japanese, and U.S. TNCs was undertaken to determine the answers to these questions, and to develop policy and procedure recommendations for both the TNCs and their respective tax authorities. Unexpected findings emerged about the relationship between transfer pricing behaviors and audit frequency, and between audit risk and advance pricing agreement status.

1. Introduction

The tax authorities of Australia, Canada, Japan and the United States (U.S.) formed the Pacific Association of Tax Administrators (PATA) in 1980 to combat income shifting, improve cross-border information flows, and forge more conciliatory relationships. A prior study detailed PATA's history, its major documents,[1] and its effects on the negotiated transfer pricing behaviors of both tax authorities and TNCs (Borkowski, 2008). This study extends that discussion by analyzing actual TNC transfer pricing practices and interactions with one or more tax authorities to answer the following questions: Are TNCs employing transfer pricing methods (TPMs) as legislated by their tax authorities[2]? What are the main determinants affecting TNC choice of a TPM? Have the benefits of PATA membership (increased information sharing and guidance on transfer pricing-related issues) yielded measurable results for TNCs? Transfer pricing audits may have increased due to information sharing among tax authorities, or decreased due to PATA's guidance on transfer pricing documentation, advance pricing agreements and mutual agreement procedures. Does usage of such programs lead to a reduction in audit risk? A survey of

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[1] PATA has produced three major documents to date: transfer pricing documentation package in 2003 (IRS, 2003), bilateral advance pricing arrangement guidelines, and mutual agreement procedure guidelines, both in 2004.

[2] Australian, Canadian and Japanese TNCs should follow Organisation for Economic Co-operation and Development guidelines (1995) for choosing transfer pricing methods, while U.S. TNC transfer pricing practices should be in accordance with the Internal Revenue Service §482 (1996) transfer pricing regulations.

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tax executives in Australian, Canadian, Japanese, and U.S. TNCs was undertaken to determine the answers to these questions and to develop policy and procedure recommendations for both the TNCs and their respective tax authorities.

The remaining six sections of this article are organized as follows: a brief review of the relevant transfer pricing literature; a discussion of contingency theory and the development of the hypotheses; an analysis of the findings by country; an analysis of the METHOD hypotheses; an analysis of the RISK hypotheses; and, the conclusions and recommendations.

2. An introduction to transfer pricing

2.1. Transfer pricing basics

Transfer pricing is an international tax strategy and management tool used by a TNC to maximize profits and minimize tax liabilities in the countries in which it operates one or more subsidiaries, divisions, or affiliates. The transfer pricing strategy assigns prices to the tangible products, intangible assets and/or services transferred across borders between the parent TNC and its subsidiaries while adhering to the complex transfer pricing regulations administered by each country's tax authority. These tax authorities require that transfer prices be set at arm's-length.[3]

Transfer pricing is considered important by both TNCs and tax authorities. The majority of today's trade is global and involves TNCs, giving cross-border transactions the potential to create transfer pricing issues and affect both the involved countries' tax revenues and the TNC's net income (Owens, 2005). The early 1990s saw Australia and the U.S. taking the lead in enforcing their transfer pricing regulations and requiring documentation, with many countries following their example in recent years. To gauge the increasing importance of transfer pricing, one need only look at the biennial transfer pricing surveys undertaken by Ernst & Young, a global accounting and consulting firm. The first survey in 1995 included TNCs from only eight countries, but the most recent study (2008) surveyed TNCs from 24 countries. It is immediately apparent that an arm's-length transfer price may not align with a TNC's profit maximization and tax minimization objectives, all of which may not align with a manager's self interest if compensation is based on the manager's divisional profits (which in turn are affected by the transfer price). In other words, the TNC is in a classic Catch 22 situation. Przysuski and Lalapet (2005) discuss these and other transfer pricing issues from the perspective of a TNC's chief financial officer, rather than from the tax officer's perspective, explaining the fundamental issue:

> Setting efficient arm's length transfer prices that aid rather than impede a multinational's strategic objectives becomes absolutely critical not only to ensure that a corporation's profit maximizing objectives are met but also to ensure transparency and fairness in setting divisional/subsidiary performance targets (Przysuski & Lalapet, 2005).

Management's choice of one transfer pricing method over another will determine a TNC's success in reconciling these competing demands.

TNCs may also use transfer pricing maneuvers to shift income from higher-tax to lower-tax jurisdictions, although the extent of such income shifting is difficult to assess with any degree of confidence. All tax authorities, both PATA-related and not, are tireless in their quest for enhanced techniques to detect income shifting but have not been very successful. An assessment of U.S. Internal Revenue Service (IRS) statistics led Sullivan (2004) to the conclusion that (1) there has been a large increase in foreign profits of U.S. multinationals despite stalled profit growth in the U.S., (2) growth of foreign profits has been particularly strong in low-tax countries, (3) the effective rate of foreign tax on foreign profits has dropped, and (4) profit rates in low-tax countries are inordinately high (suggesting inappropriate income shifting).

2.2. The tax authorities and transfer pricing methods

While the definition of transfer pricing enjoys cross-border agreement among tax authorities, those entities exhibit lesser degrees of harmony regarding other transfer pricing issues. The PATA tax authorities are the Australian Taxation Office (ATO), the Canadian Revenue Agency (CRA), the Japanese National Tax Agency (NTA), and the U.S. IRS. These authorities administer some of the most comprehensive transfer pricing legislation in the world and offer some of the best developed advance pricing agreement and mutual agreement procedure programs available to interested TNCs. These and other details (some adapted from Deloitte Touche Tohmatsu, 2004) are presented in Table 1. Approved TPMs[4] are defined in the Organization for Economic Co-operation and Development's (OECD) 1995 transfer pricing guidelines (followed by Australia, Canada and Japan) and in Section 482 (§482) of the Internal Revenue Code for transferred tangible goods and intangible assets. Methods are classified as transaction-based or profit-based.

Transaction-based methods for tangible goods include the comparable uncontrolled price (CUP, also called market) method; the resale price method; and, the cost-plus method. Profit-based methods include the comparable profits method (CPM, accepted only by the IRS), the transaction net margin method (TNMM, accepted only in OECD-based countries), and

[3] A transaction is considered to be at arm's length if the price charged by one related party to the other related party approximates the price that would have been charged for a transaction between two unrelated parties.

[4] Detailed discussions of acceptable transfer pricing methods are given in §482 of the U.S. Internal Revenue Code (IRS, 1996), and in the OECD Transfer Pricing Guidelines (1995).