

Transfer Pricing: Strategies, Practices, and Tax Minimization

Kenneth Klassen, University of Waterloo; Petro Lisowsky, University of Illinois of Urbana-Champaign; and Devan Mescall, University of Saskatchewan¹

In cooperation with the Tax Executives Institute (TEI), we conducted an extensive field survey of 219 multinational company tax directors to provide a detailed account from within multinational corporations of differences in transfer pricing practices and strategies, and their role in tax minimization. Transfer pricing in a tax setting is a topic shared across accounting, economics, and law disciplines. Within this broad literature, the complexities of transfer pricing are often simplified while transfer prices themselves are seen as an important tool for multinational firms to reduce global taxes. For example, Hassett and Newmark (2008) state that one mechanism for income shifting is tax-motivated transfer pricing, defining this phenomenon as “the practice of multinational corporations of arranging intrafirm sales such that most of the profit is made in a low-tax country” (p. 208). Media accounts reinforce this perception and blame opportunistic transfer pricing for the low amount of taxes paid by large companies in countries such as the U.K., including specific mentions of Google, eBay, and Starbucks (Bergin 2012 and Milne 2012). However, broader views of tax strategy (e.g., Scholes and Wolfson 1992) suggest such one-dimensional analyses ignore other uses of the transfer prices, e.g., to support decentralization and coordination (Baldenius et al. 2004).

Due to the proprietary nature of transfer prices, documenting evidence of whether and how much transfer pricing facilitates tax avoidance is challenging. Researchers are generally left with data that provide only an external, indirect view of firms’ operations and internal transactions (Gordon and Hines 2002; Jacob 1996). In addition, there are many challenges in identifying international tax planning from financial statements (see Donohoe et al. 2012), leaving researchers to use less conventional methods and data sources. For example, Blouin et al. (2012) use proprietary data from the Bureau of Economic Analysis (BEA) to examine transfer pricing within firms. We complement these studies by using our TEI survey participants to directly evaluate the links between transfer pricing and corporate tax minimization.

The goal of this study is to provide a detailed analysis of the role of tax departments in the setting of transfer prices. We undertake this analysis to inform tax policy setters, practitioners, advisors, and researchers studying this growing area of activity. Global tax authorities have raised concern about the loss of tax revenues that may be the result of aggressive transfer pricing practices (OECD 2013). In 2010, the U.S. Internal Revenue Service (IRS) announced a greater focus on transfer pricing to address potential revenue loss including plans to increase staffing by creating a new Director of Transfer Pricing position, which was filled in 2011 (Ossi and Shepherd 2010). The global professional services firm Ernst & Young (E&Y) began surveying tax authorities in 1995, and in their most recent survey of 48 tax authorities in 2012, they conclude:

“One constant runs through the history of the survey: tax authorities continue to add staff devoted to transfer pricing. In a climate of budget freezes for many government agencies, tax authorities appear to have made the cost/benefit calculation to incur additional staffing costs in order to investigate transfer pricing. The penalty burden is also increasing.” (Ernst & Young 2012, p. 7)

Given the tax enforcement environment, aggressively using transfer prices to reduce taxes may not be optimal for all companies. In fact, the same E&Y report also advises that “[t]axpayers should not be complacent about their transfer pricing risk” and recommends that “[c]ompanies should pursue tax certainty” (p. 5). This sentiment is echoed by Alvarez and Marsal Taxand’s 2012 survey of chief financial officers who identify transfer

¹ University of Waterloo, University of Illinois at Urbana-Champaign, and University of Saskatchewan, respectively. The authors thank Tax Executives Institute (TEI) for distributing our survey and TEI members for their participation. Special thanks for the cooperation and support of Timothy McCormally and Mary Fahey. The authors thank Marc Alms, Andrew Bauer, Muris Dujic, Christy MacDonald, Paula Moore, and Leslie Robinson for assistance in developing our survey instrument; workshop participants at the University of Iowa for helpful comments; and Stephen Powers for excellent research assistance. Finally, Kenneth Klassen acknowledges the generous support of the Robert Harding Research Leadership Fellowship at the University of Waterloo, and Petro Lisowsky acknowledges the generous support of the PricewaterhouseCoopers Faculty Fellowship at the University of Illinois.

pricing as the largest tax risk facing multinational companies. In the academic literature, Towery (2013) finds that the second-largest area of corporate income tax uncertainty as disclosed on the IRS's Schedule UTP in 2010 is related to international transfer pricing. Also, Mescall and Klassen (2013) find that increased tax risk related to strict transfer pricing enforcement adversely impacts cross-border merger and acquisition premia. Given the growing focus on minimizing tax risk, it is therefore unclear for which multinational corporations transfer pricing is a useful tool for tax minimization, and for which corporations the operational and enforcement costs are too great to risk implementing aggressive transfer pricing strategies.

We provide a rich, detailed, and direct account of transfer pricing for tax purposes, as reported by multinational corporations' tax departments. Our survey shows that a larger proportion of multinational firms assess their transfer pricing practices on *compliance-based* measures than on *tax minimization* measures, contrary to stereotypes on the (near) ubiquitous exploitation of transfer prices by multinational firms to reduce their tax burdens.² We also find that, among transfer pricing strategies, nonmanufacturing firms are more likely to adopt a goal of tax minimization than manufacturing firms. In addition, firms with less intense internationalization are more likely to pursue a goal of tax compliance as opposed to minimization. These results are consistent with the transfer pricing literature that uses indirect evidence. We also find that transfer pricing consumes, on average, a larger proportion of tax budgets in nonmanufacturing firms and firms with more intense internationalization. Similarly, firms that assess their transfer pricing success using a goal of tax minimization spend a higher percentage of their transfer pricing resources on tax planning compared to firms that assess their transfer pricing success using a goal of tax compliance.

Our data reveal that firms assessing transfer pricing success using the goal of tax minimization have more experienced personnel, more well-funded internal tax departments, and more resources devoted to tax planning. Further, the frequency of managers citing a goal of tax minimization increases when the firms' transfer pricing objectives focus on reducing cash taxes paid. In multivariate analyses, we estimate that focusing on cash taxes as a goal of transfer pricing reduces effective tax rates (ETRs) by approximately 3.7 percentage points. Yet firms that focus on tax compliance to assess the success of their transfer pricing practices report ETRs that are 5.4 percentage points higher than firms claiming neither goal.

Finally, our respondents report that over the past decade, transfer pricing has become a larger portion of firms' overall tax budgets. Over half of our respondents indicated that their transfer pricing functions are underfunded, although we find no evidence that compliance burdens have resulted in tax planning being inaccessible to smaller firms. Overall, our unique survey data allow us to refine our understanding of when transfer pricing results (and does not result) in tax reduction. We highlight that transfer pricing opportunities do not result in uniform tax minimization across all multinationals because firm-specific strategies and practices differ substantially across these firms.

In sum, our study is a first step towards providing new and direct evidence on the role of transfer pricing in tax minimization. The results should interest researchers, practitioners, and tax authorities interested in the growing area of transfer pricing implementation and compliance. Although our evidence shows that transfer pricing is a material tax minimization tool and that a significant number of firms are evaluating their transfer pricing success based on tax minimization, we also provide strong evidence that even more frequent are multinationals' goal to comply with international tax laws.

² Although it is possible that the respondents are more reluctant to suggest that their goals lean more toward tax minimization rather than tax compliance, our multivariate regression tests show that their perception of how they are measured is indeed strongly linked to the actual effective tax rates reported by these firms. Thus, to the extent the respondents distort how their transfer pricing practices are evaluated, it would only work against us finding significant results when testing their link to GAAP effective tax rates.

References

- Alvarez, and Marsal, (2012). "CFO Matters: Tax Perspectives Survey Highlights." Available online at: http://www.alvarezandmarsal.com/en/about/action_matters/documents/CFOSurvey_FINAL_002.pdf.
- Baldenius, T., N. Melumad, and S. Reichelstein. (2004). "Integrating Managerial and Tax Objectives in Transfer Pricing." *The Accounting Review* 79 (3): 591–615.
- Bergin, T. (2012) "How Starbucks Avoids Paying Taxes in The U.K." National Post (October 17, 2012). Available online at: <http://business.financialpost.com/2012/10/17/how-starbucks-avoids-paying-tax-in-the-u-k/>.
- Blouin, J., L. Robinson, and J. Seidman. (2012). "Conflicting Transfer Pricing Incentives and the Role of Coordination," Working paper.
- Donohoe, M., G. McGill, and E. Outslay (2012). "Through a glass darkly: What can we learn about a U.S. multinational corporation's international operations from its financial statement disclosures?" *National Tax Journal*, 65 (4): 961–984.
- Ernst & Young (E&Y). (2012). "2012 Global Transfer Pricing Tax Authority Survey" *EYGM Limited*. Available online at: [http://www.ey.com/Publication/vwLUAssets/2012-Global-TP-Tax-Authority-Survey/\\$FILE/2012-Global-TP-Tax-Authority-Survey.pdf](http://www.ey.com/Publication/vwLUAssets/2012-Global-TP-Tax-Authority-Survey/$FILE/2012-Global-TP-Tax-Authority-Survey.pdf).
- Gordon, R.H., and J.R. Hines, Jr. (2002). "International Taxation." In: *Handbook of Public Economics* vol. 4, A. Auerbach and M. Feldstein. (Eds.), Amsterdam: North-Holland.
- Hassett, K., and K. Newmark. (2008). "Taxation and Business Behavior: A Review of the Recent Literature." In: *Fundamental Tax Reform: Issues, Choices and Implications*. Diamond, J., Zodrow, G. (Eds.), MIT Press, Cambridge: 191–214.
- Jacob, John. (1996). "Taxes and Transfer Pricing: Income Shifting and the Volume of Intrafirm Transfers." *Journal of Accounting Research* 34 (2): 301–312.
- Mescall, D. and K. Klassen. (2013). "How does transfer pricing risk affect premia in cross-border mergers and acquisitions?" Working paper.
- Milne S. (2012). "A Roll Call of Corporate Rogues Who Are Milking The Country" *The Guardian*. Available online at: <http://www.guardian.co.uk/commentisfree/2012/oct/30/roll-call-corporate-rogues-tax>.
- OECD. (2013). *Addressing Base Erosion and Profit Shifting*, OECD Publishing. Available at: <http://dx.doi.org/10.1787/9789264192744-en>.
- Ossi, G. and M. Shepherd. (2010). "The IRS's Emphasis on Transfer Pricing." *Corporate Taxation* 37 (4): 3–6.
- Scholes, M., and M. Wolfson. (1992). *Taxes and Business Strategy: A Planning Approach*. Englewood Cliffs, NJ: Prentice-Hall.
- Towery, E. (2013). "How Do Disclosures of Tax Aggressiveness to Tax Authorities Affect Reporting Decisions? Evidence from Schedule UTP" Working paper.