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AT URBANA-CHAMPAIGN

Transfer Pricing: Strategies, Practices, and Tax Minimization

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Research Question

- How do U.S. multinational corporations' transfer pricing strategies and practices affect their tax minimization outcomes?

- Objective: Critically examine role of transfer pricing in corporate tax avoidance (Hanlon and Heitzman 2010)

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Multinational Corporation **= Tax Avoider**

- "Asda, Google, Apple, eBay, Ikea, Starbucks, Vodafone: all pay minimal tax on massive UK revenues, mostly by diverting profits earned in Britain to their parent companies, or lower tax jurisdictions via royalty and service payments." – The Guardian Oct 31, 2012

How?…   Transfer Pricing!

- "Transfer pricing is the practice of multinational corporations of arranging intrafirm sales such that most of the profit is made in a low-tax country." - Hassett and Newmark (2008)
- The Economist, Feb 16, 2013:
  - "One of the main vehicles of corporate tax avoidance is a practice known as transfer pricing."
  - "Transfer pricing (really mispricing) is sometimes also used to load costs onto countries that offer generous subsidies… It has become a key plank of multinational tax strategies."

Transfer Pricing: The Basics

U.S. Parent (t=35%) → Irish Subsidiary (t=12.5%)

Items sold at/near cost.
--U.S. recognizes little income
--Costs are deducted in high-tax U.S. jurisdiction
--Cash gets to U.S. without paying repatriation tax

Items sold to customers at high mark-up.
--Ireland recognizes high income
--High income lightly taxed
--Can send to other countries for sale and it will not be subject to Irish tax.

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Transfer Pricing: The Basics

- Better Strategy:

U.S. Parent (t=35%)

Irish Subsidiary (t=12.5%)

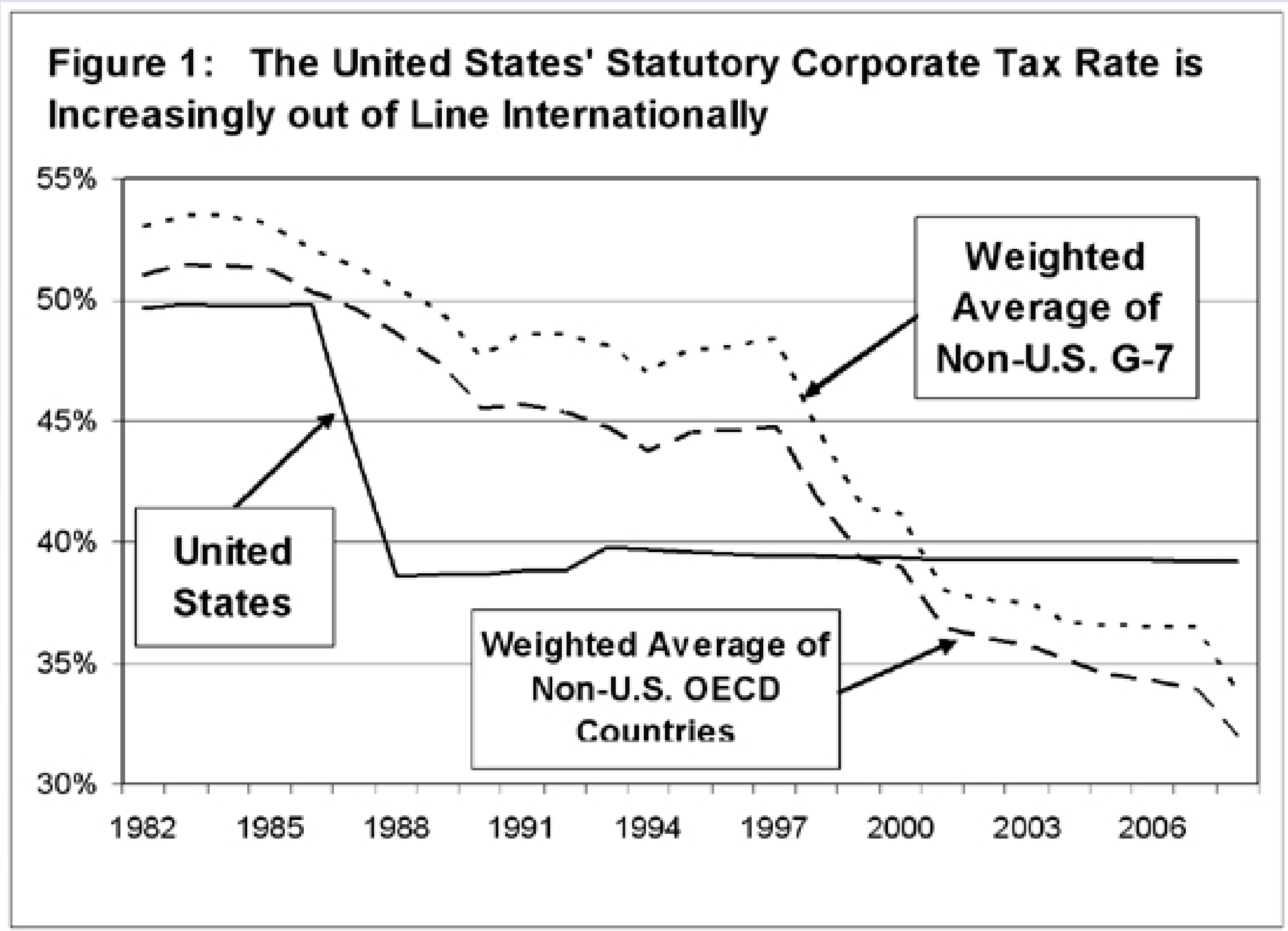
Items sold at/near cost.
--U.S. recognizes little income
--High Costs are deducted in high-tax jurisdiction
--Cash gets to U.S. without paying repatriation tax

Items purchased from Bermuda have a high mark-up = high cost.
--Recognize little income in Ireland (and what you do gets lightly taxed)

Bermuda Subsidiary (t = 0%)

Items sold at very high mark-up.
--Bermuda recognizes very high income
--High income not taxed at all.
--Lax regulatory regime
--Cash gets to Bermuda from Ireland

U.S.: From "Tax Haven" to High Taxed



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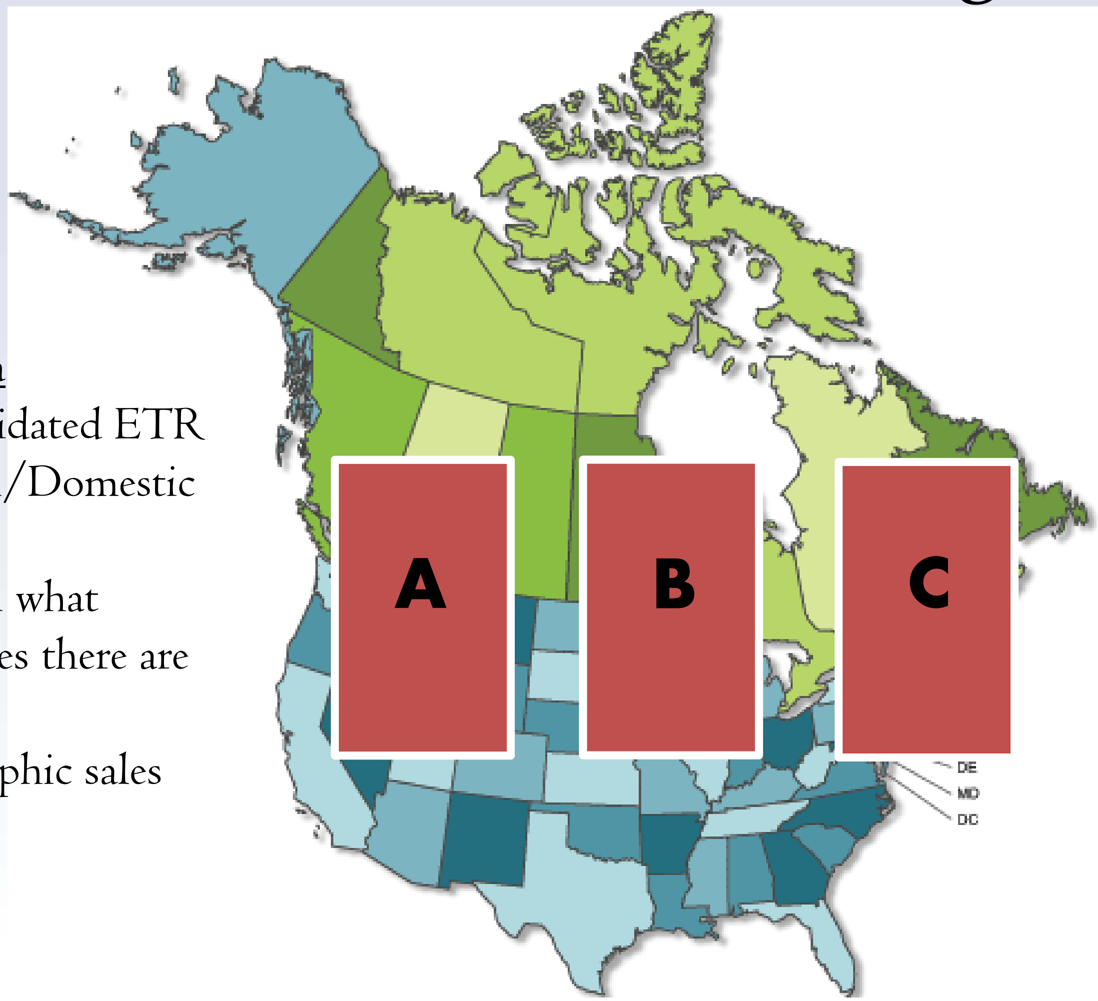
Source: OECD and Tax Foundation "Fiscal Fact" by Robert Carroll

Do Multinationals Avoid Taxes via Transfer Pricing?



Public data
- Consolidated ETR
- Foreign/Domestic ETR
- 10K: in what countries there are entities
- Geographic sales

Prior Research:

- Klassen, Lang, and Wolfson (1993)
- Jacob (1996)
- Dyreng and Lindsey (2009)
- Donohoe, McGill and Outslay (2012)
- Dyreng and Markle (2013 WP)

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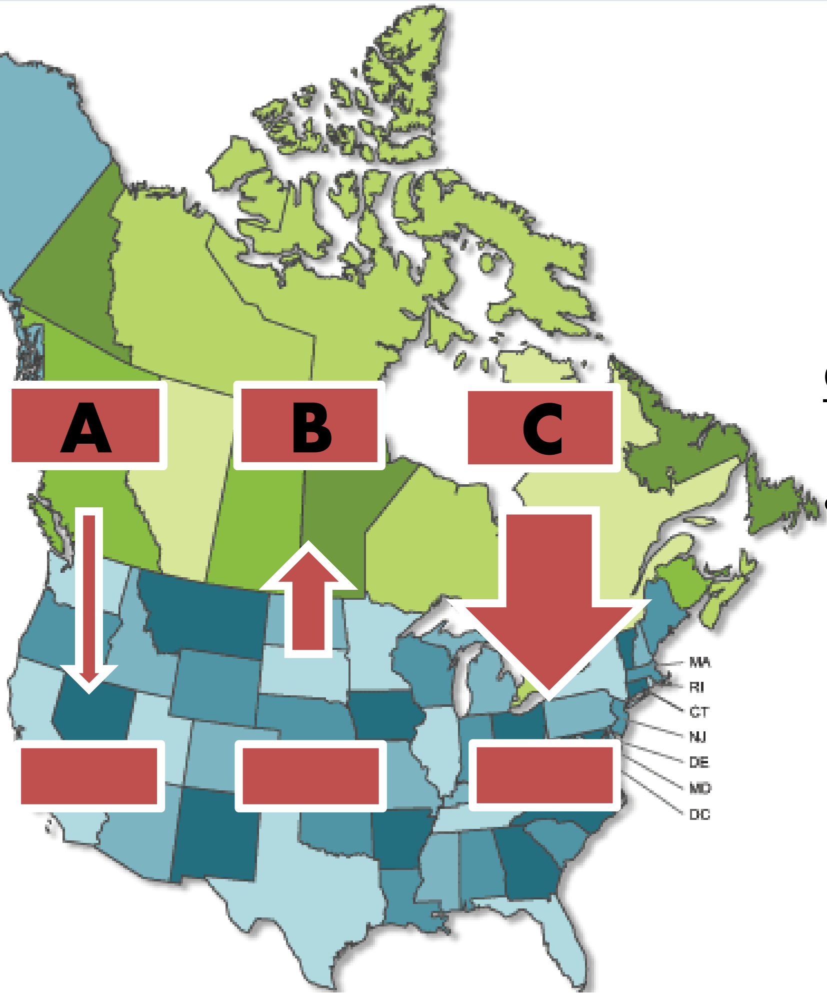
Do Multinationals Avoid Taxes via Transfer Pricing?

<u>Other data</u>

BEA
- Size of transfers by firm between countries
- Country-level intrafirm trade



<u>Current Research</u>:

- Blouin, Robinson, and Seidman (2012)

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Conclusion

- Multinational corporations use transfer pricing to avoid taxes.
- But …

Tax Authorities are Reacting

I pity the fool who abuses transfer prices!

- "IRS Brings '**A Team**' to Crush Transfer Pricing Abuse" – Forbes March 2012
- "OECD Urges International Tax Clampdown on Multinationals" – Reuters Feb 13, 2013

Multinationals Seeking Certainty

- "Companies should pursue tax certainty" – E&Y 2012
- "What you need is certainty and that's what you don't get in India" – KPMG 2013
- Arm's length principle: not easy to determine.
- Advance Pricing Agreements (APA)
- "Competent Authority" arbitration
  - Resolution of TP between firm & *n* countries' tax authorities
  - However, not binding

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Variation in the Tax Function

- MNCs' approaches to taxes are not uniform
- Firms balance tax incentives with nontax & financial reporting effects differently
  - Graham, Hanlon, and Shevlin (2010, 2011)
- Tax department goals can be different, and affect ETRs differently
  - Robinson, Sikes, and Weaver (2010)
- Transfer pricing tax function remains unexplored

How is Tax Minimization affected by Firm-Specific Transfer Pricing Goals and Practices?

<u>Our Survey Data</u>

- Assess effectiveness of Transfer Pricing Practice
- Experience of Tax Director
- Budget for Transfer Pricing
- Mix of Planning and Compliance

Survey

- Obtain inside tax information from 219 MNCs
  - Traditional archival data sources are inadequate
- In cooperation with Tax Executives Institute (TEI)
- Survey ran October - December 2010
- Sent to every Int'l TEI member, plus one reminder
  - Response Rate = 8.1%
- Responses are optional
  - Consistent with previous surveys (GHS 2010, 2011)

Survey Caveats

- Voluntary responses
- Respondent must be member of TEI
- Potential interpretation issues
- Remedies:
  - Asked who filled out survey:
    - VP Tax (39%), Tax Director (40%), Tax Manager (19%), CFO (2%)
  - Validated demographics on external data: Our survey vs. 2005 mandatory TEI survey (Table 1)

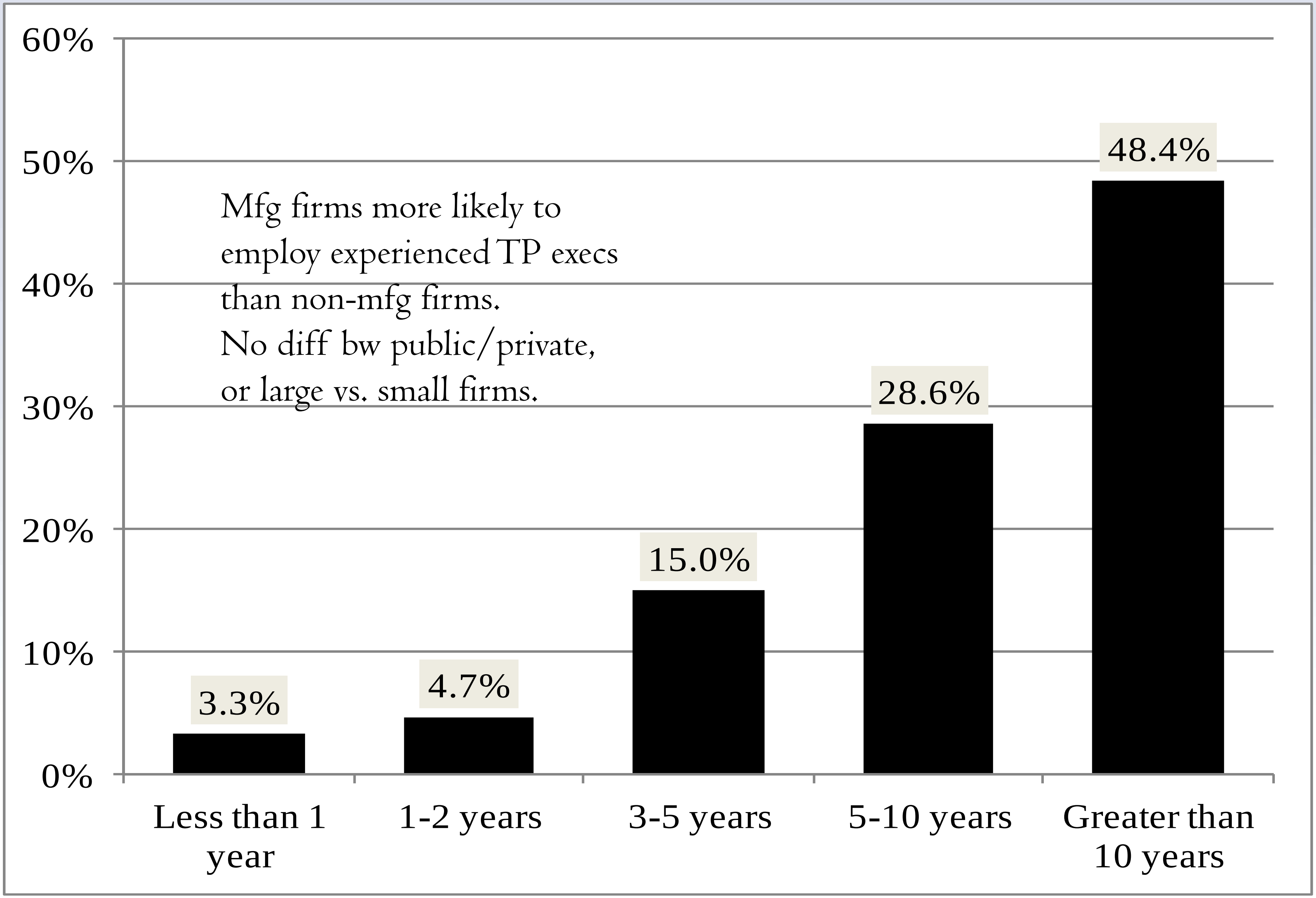
Survey Analysis

- Responses Overall
- Responses by Firm Characteristic

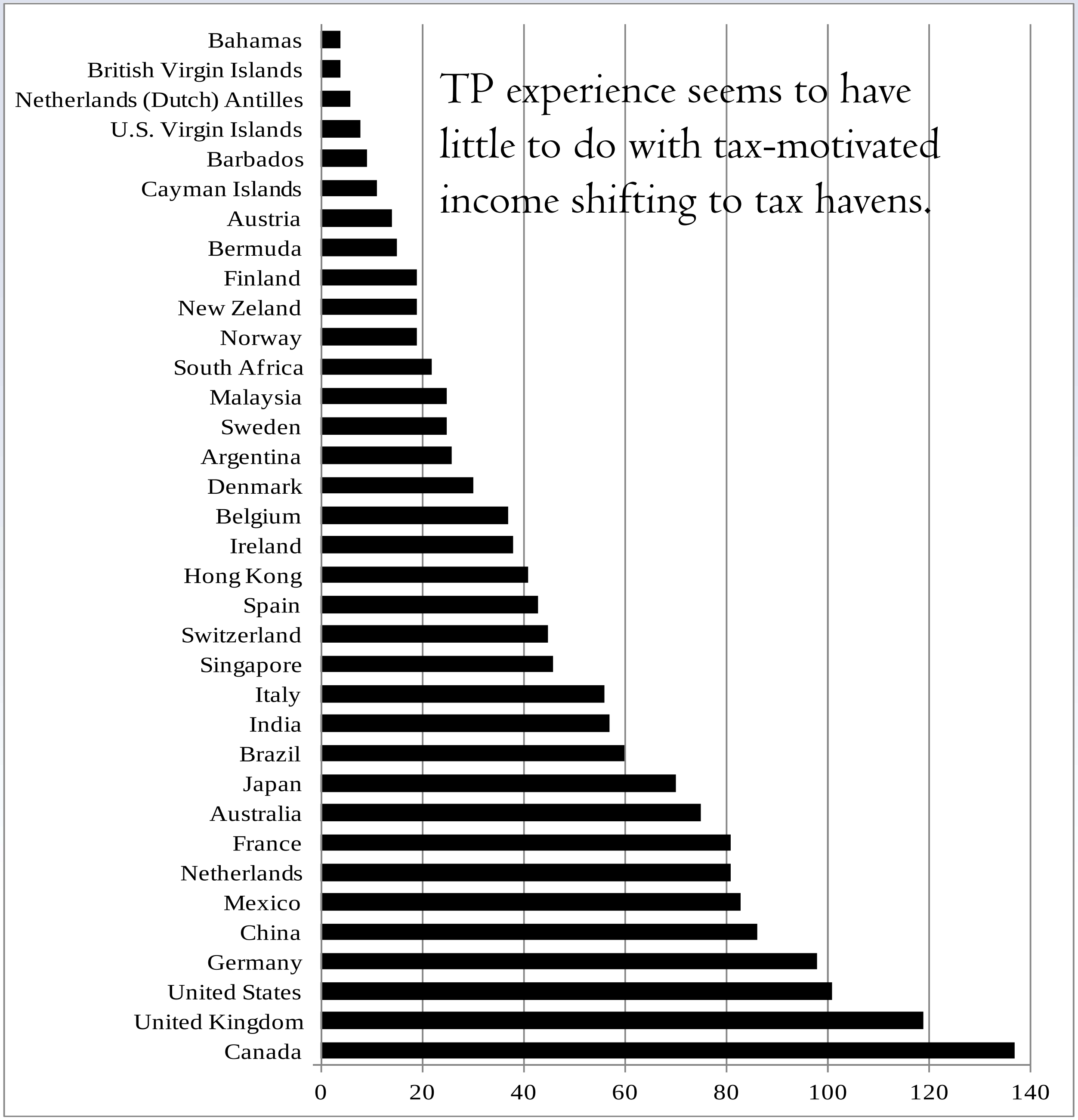
ETR	R&D
International Exposure	TP Experience
Tax Budget	NOL
Tax Planner	Underfunded TP
Asset Size	Public
Low Cash Tax Goal	Compliance Goal

- OLS regression
  - Provide a multivariate control framework

Number of Years of Transfer Pricing Experience



#Respondents with TP Experience in Countries



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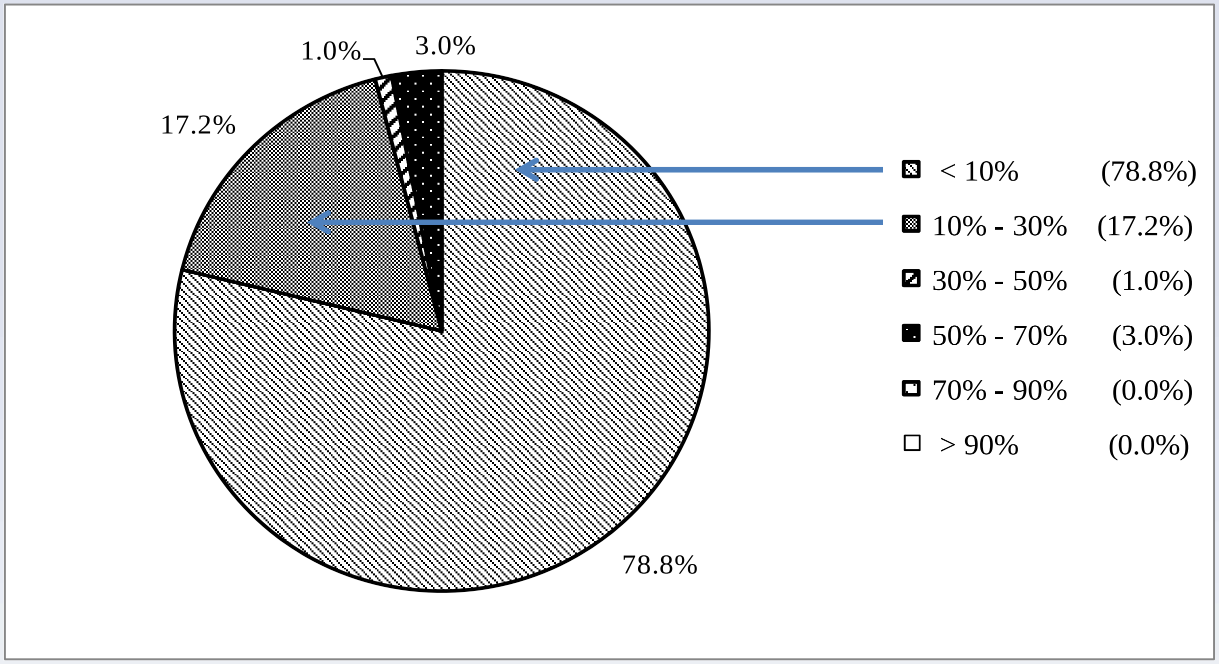
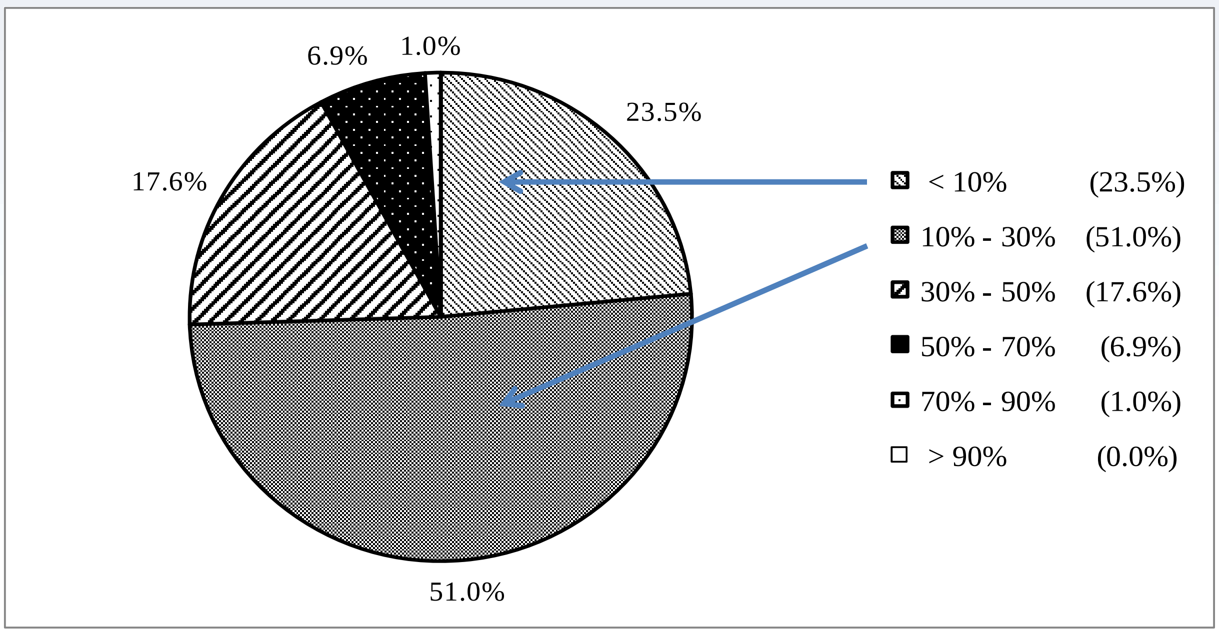
Tax Resources Consumed by Transfer Pricing

10 Years Ago:



Non-mfg, high intl, more experienced tax directors spend higher % of resources on TP.

Current Year:



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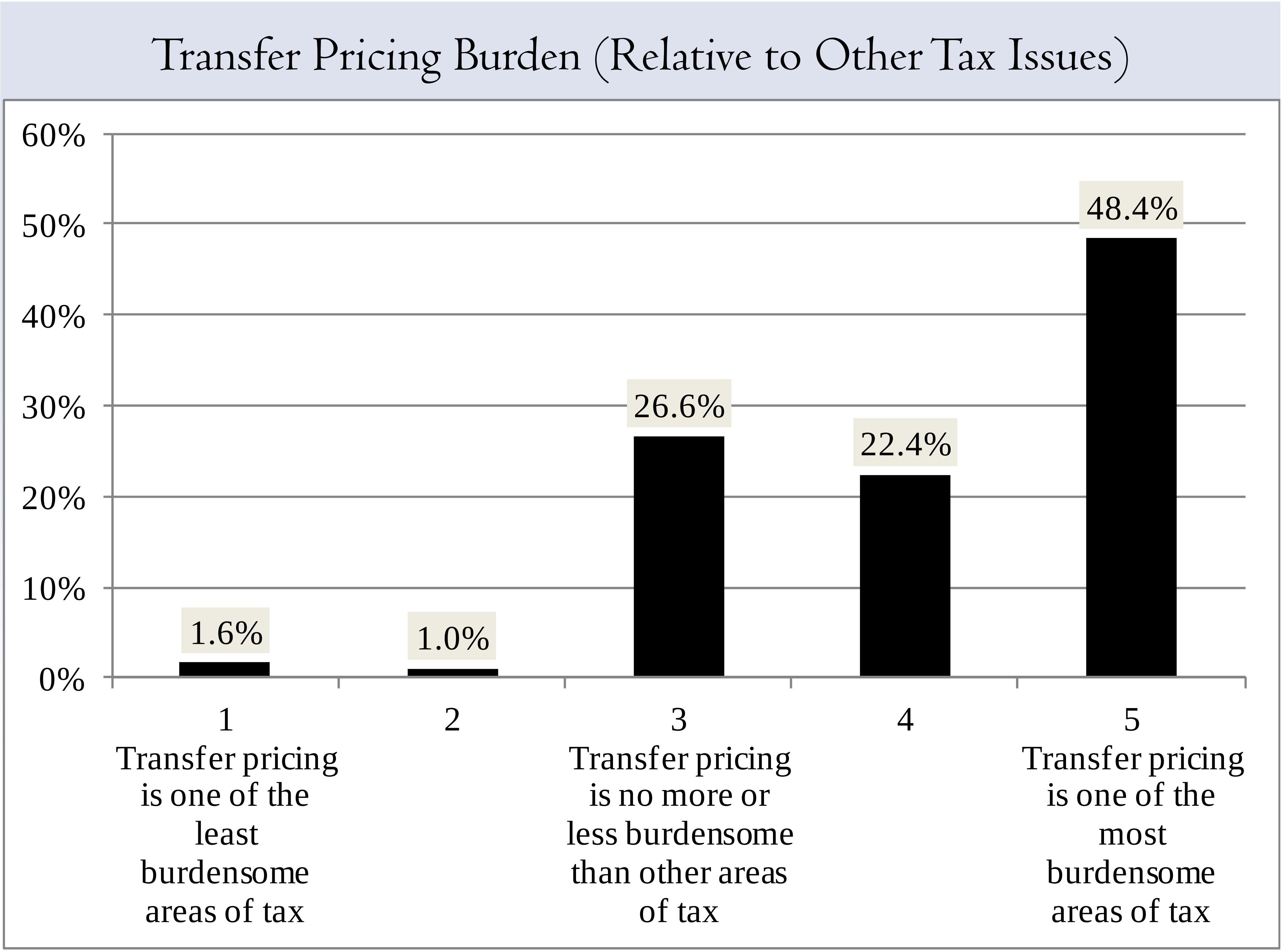
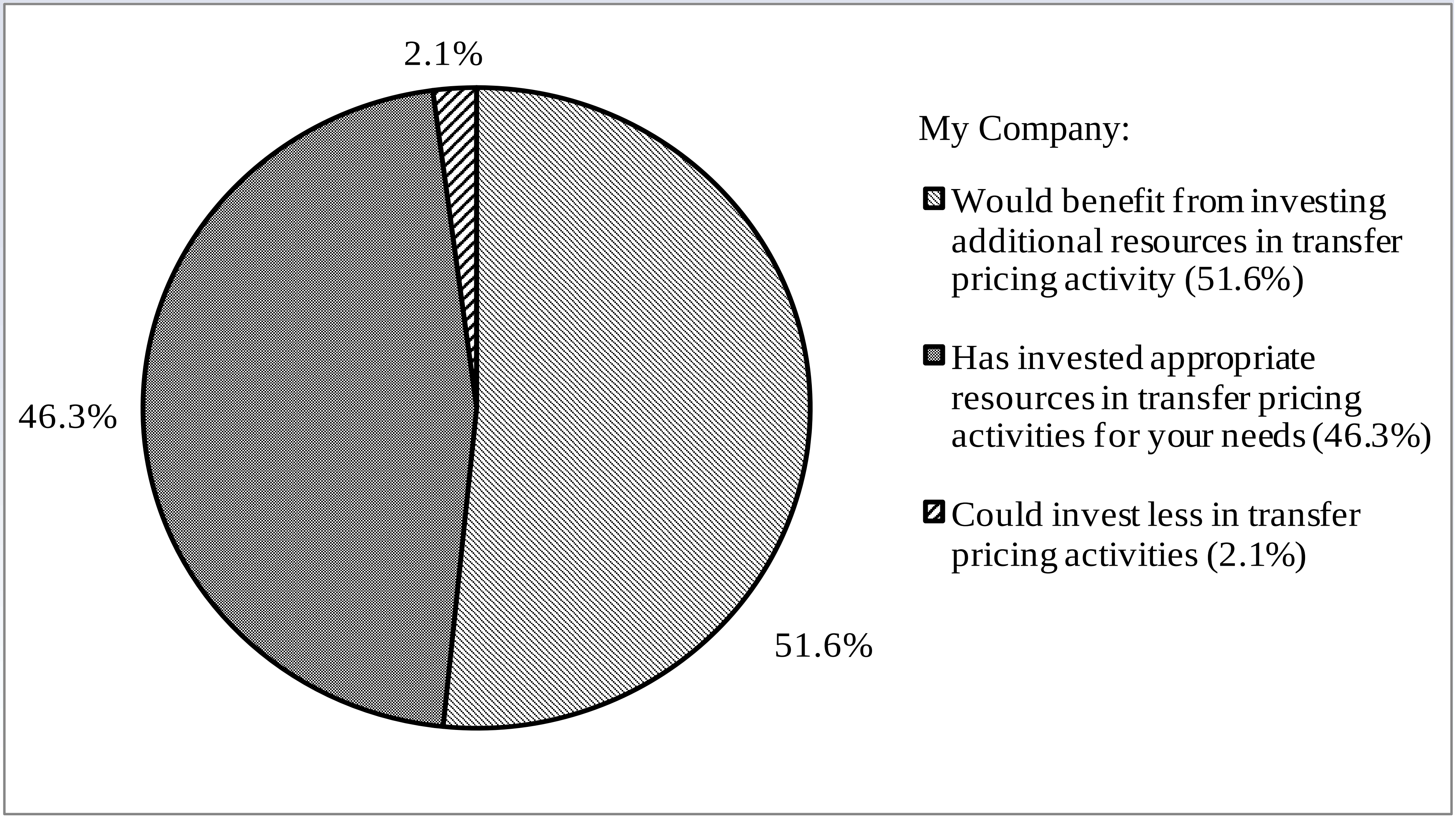
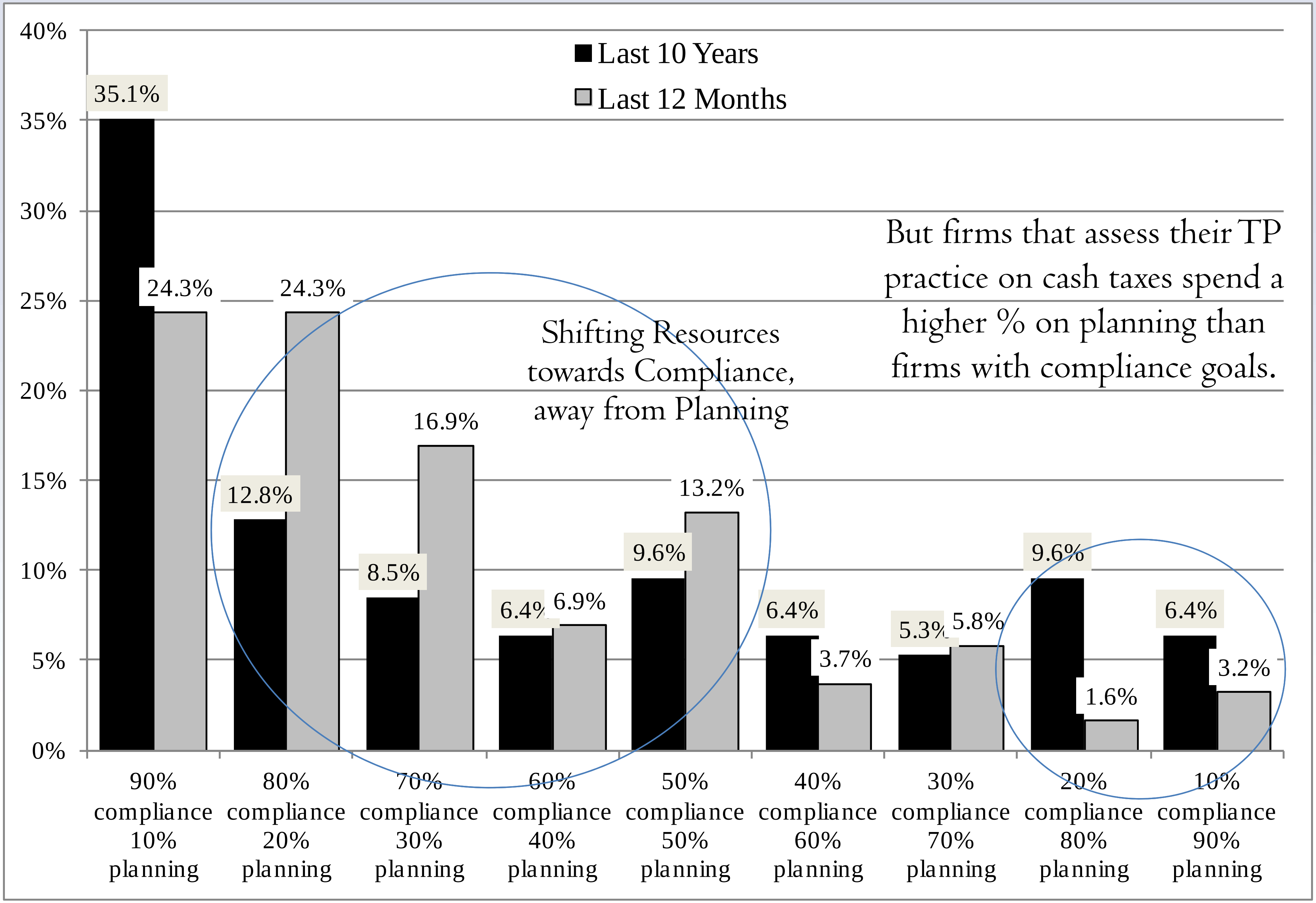

Transfer Pricing Burden (Relative to Other Tax Issues)
60%
50%
40%
30%
20%
10%
0%
1.6%
1.0%
26.6%
22.4%
48.4%
1
Transfer pricing is one of the least burdensome areas of tax
2
3
Transfer pricing is no more or less burdensome than other areas of tax
4
5
Transfer pricing is one of the most burdensome areas of tax

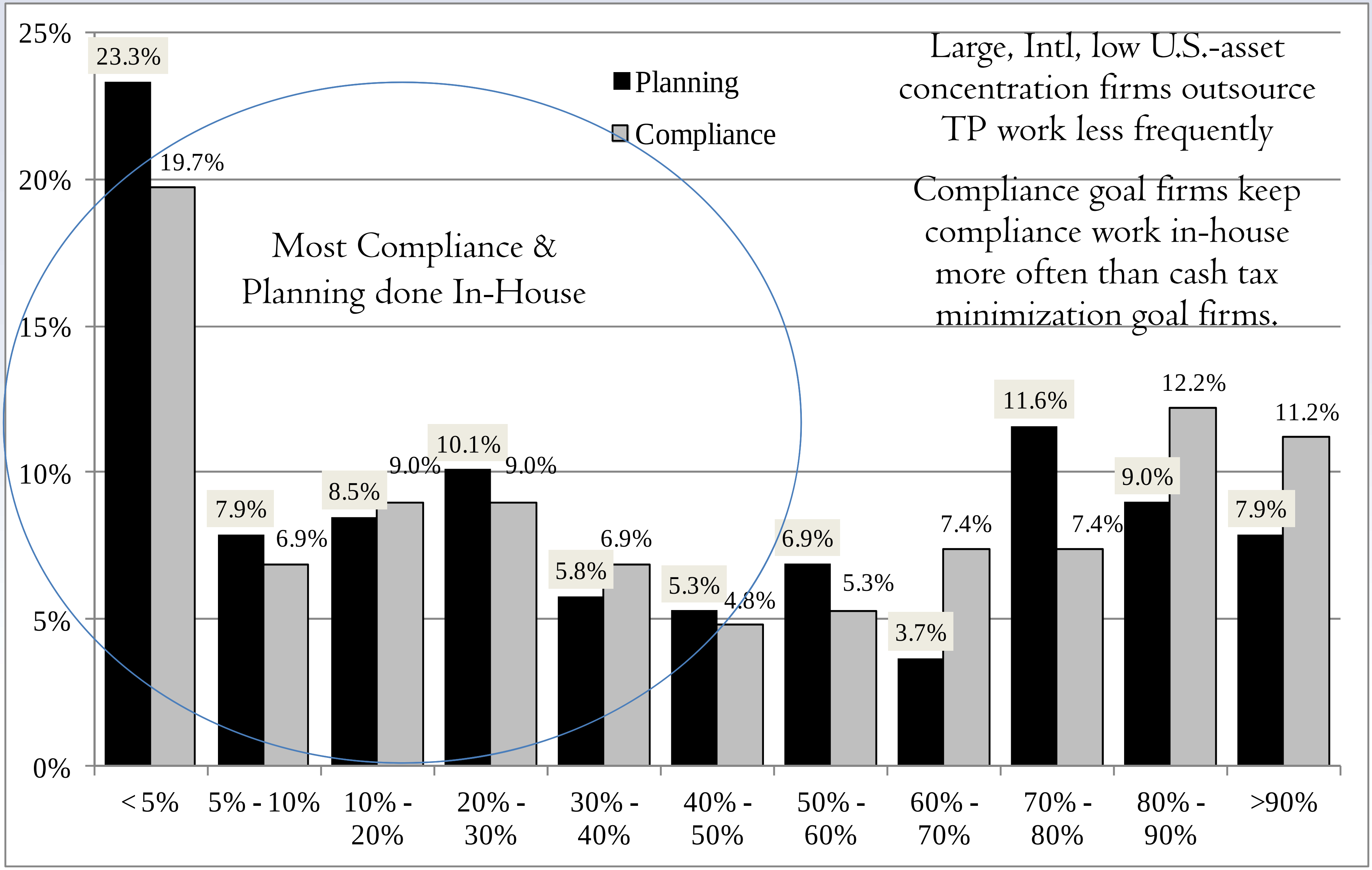
Resource Adequacy for Transfer Pricing



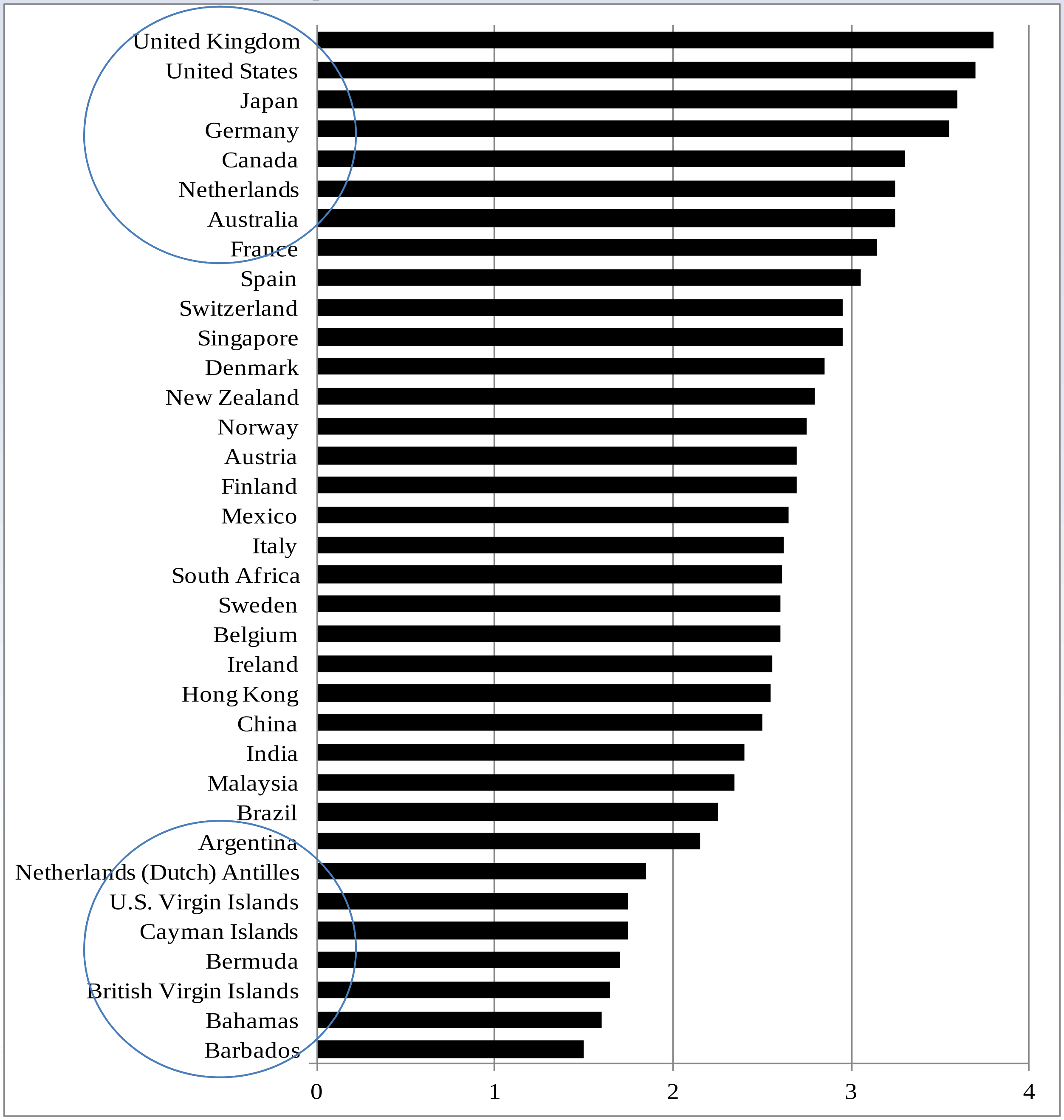
Transfer Pricing Compliance vs. Planning Resources



% of Transfer Pricing Compliance & Planning Outsourced

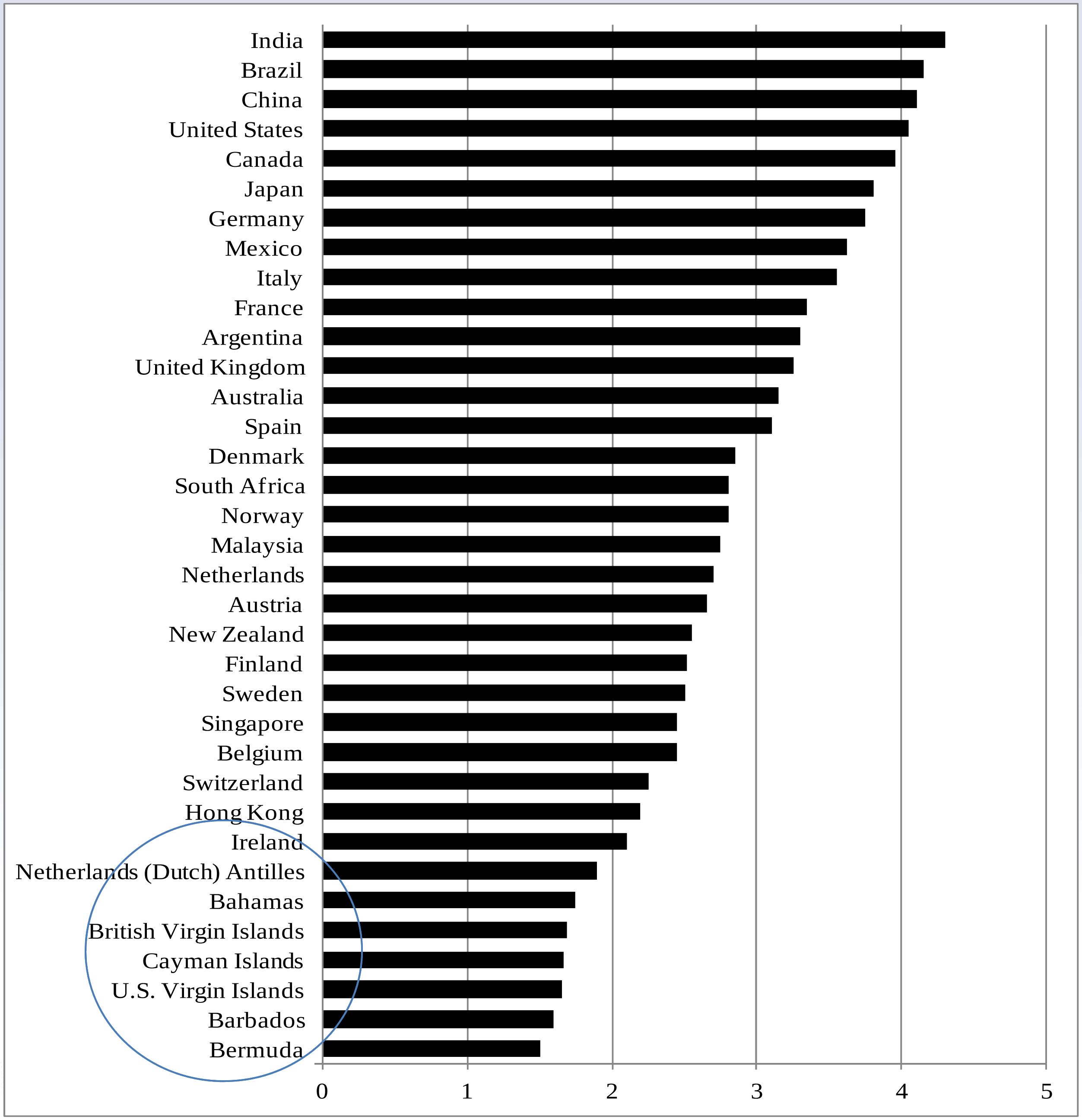


Quality of Tax Authorities' TP Auditors (5=best)



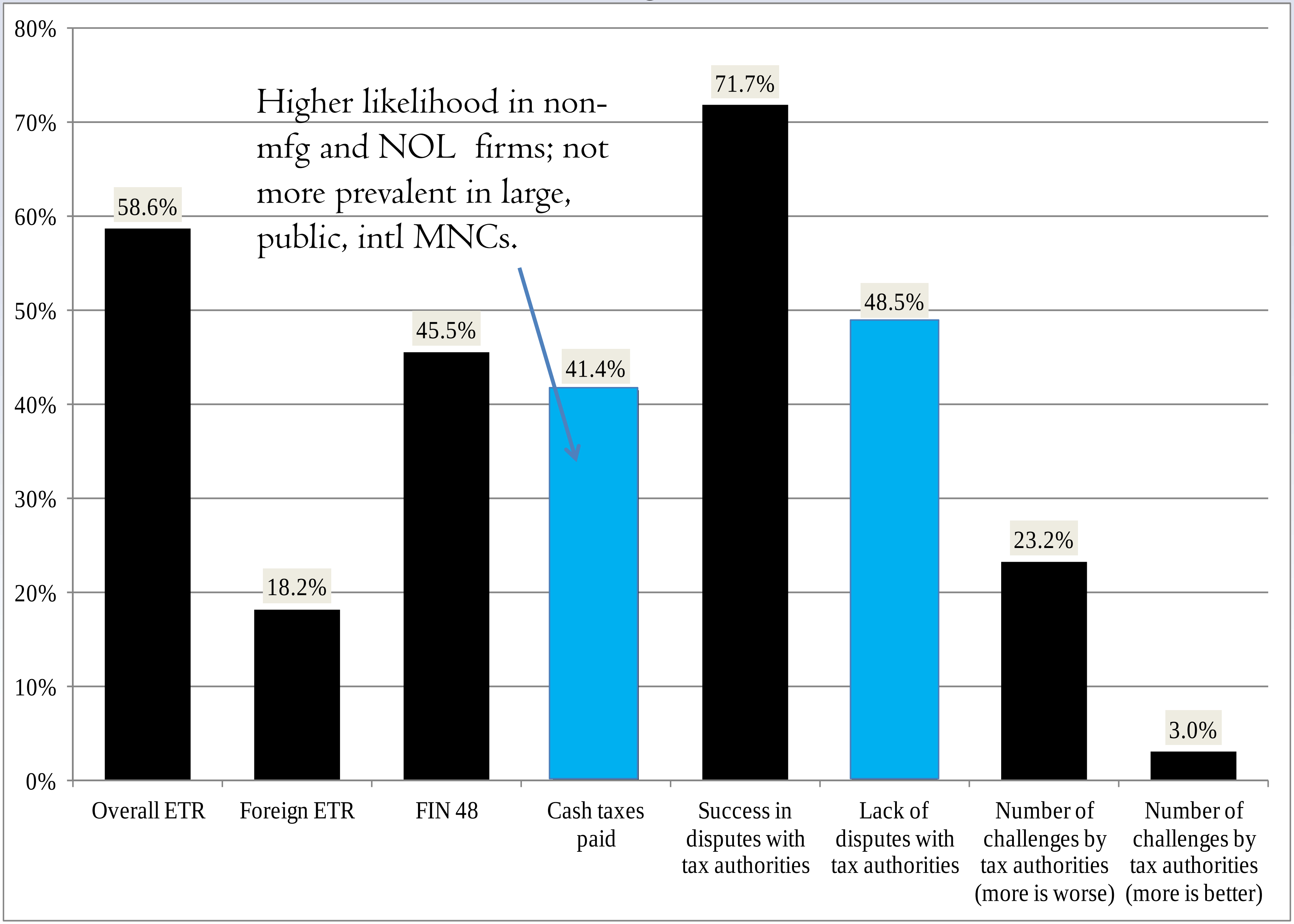
More mfg than non-mfg firms operate in high-quality jurisdictions

Transfer Pricing Risk by Country (5=most risky)



Public, large, and high non-U.S. asset firms operate in riskier TP countries.

Goals of Transfer Pricing Practice within MNC



Link Between Tax Minimization and Firm-Specific TP Attributes

Correlation Coefficients	ETR
Low Cash Tax Goal	-0.22**
Compliance Goal	0.28**
High International	-0.24**
Tax Budget	-0.19
High Planner	-0.12
Assets (Logged)	-0.26**
R&D	-0.25**
TP Experience	-0.28**
NOL	0.02
Underfunded TP	0.14
Public	-0.17*
Tax Haven Benefit	-0.07

OLS Results. Dep. Variable: ETR	(1)	(2)	(3)
Low Cash Tax Goal	-0.037***		
Compliance Goal	0.054***		
Low Cash Tax Goal Only		-0.062***	
Compliance Goal Only			0.064***
High International	-0.008	-0.013	-0.011
Tax Budget	-14.98***	-15.290***	-17.110***
High Planner	-0.032**	-0.028*	-0.027
Assets (Logged)	-0.018***	-0.018***	-0.019***
R&D	-0.075***	-0.076***	-0.076***
TP Experience	-0.043*	-0.044*	-0.043**
NOL	0.012	0.011	0.014
Underfunded TP	0.035	0.034	0.035
Public	-0.026	-0.029*	-0.020
Tax Haven Benefit	-0.067***	-0.054***	-0.063***
Constant	0.496***	0.539***	0.495***
Adjusted R^2	*51.9%*	*48.2%*	*49.7%*
n	*65*	*65*	*65*

Conclusions

- Do MNCs avoid taxes through transfer pricing?
- It Depends!...
  - On how TP practice is assessed: compliance vs. avoidance
  - On financial resources for TP (budget)
  - On human capital (experience)
- Importantly, more MNCs now seem to be concerned about tax *compliance* than tax *minimization*.

Thank You!

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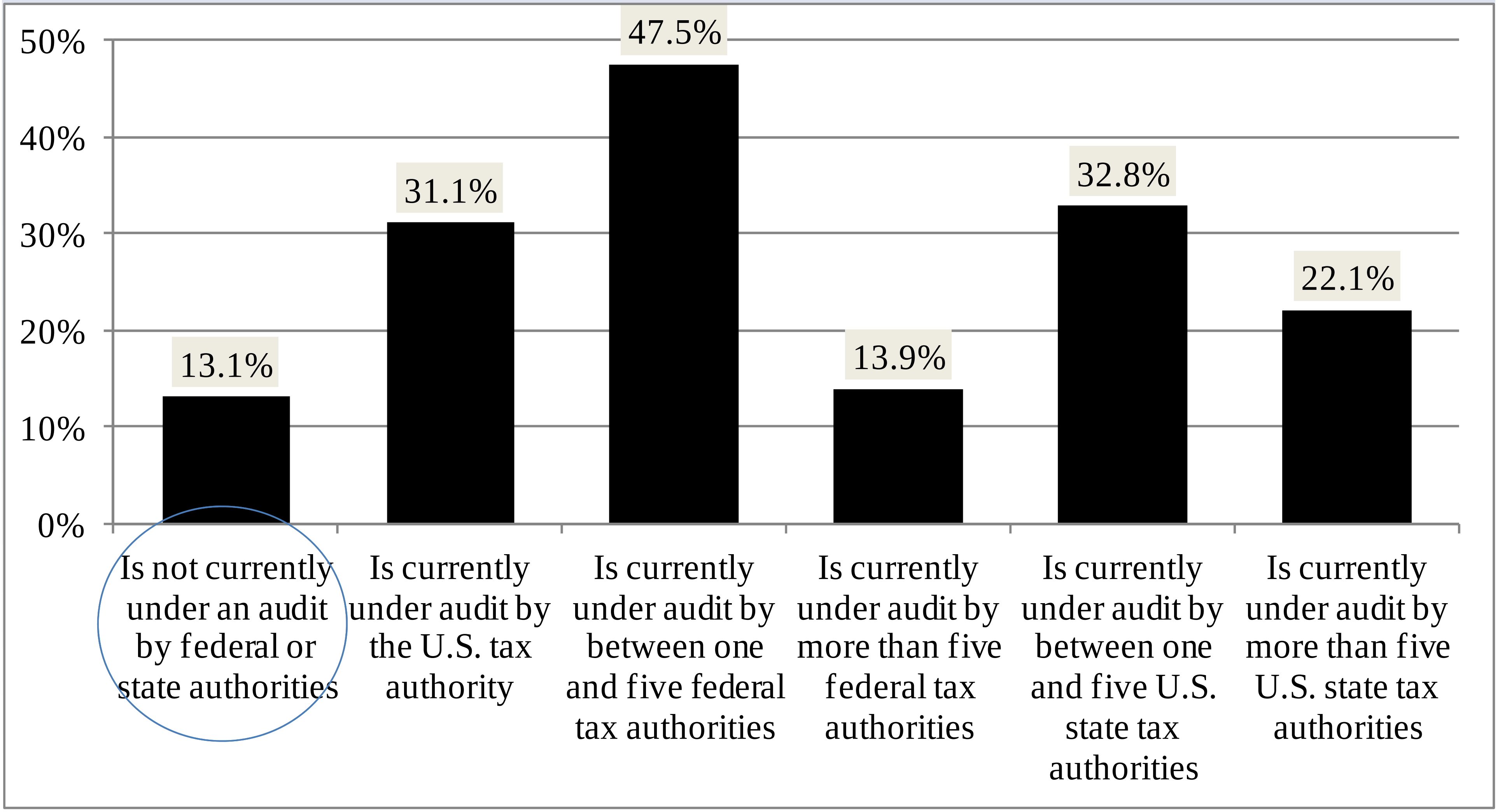
Tax Environment: Tax Audit



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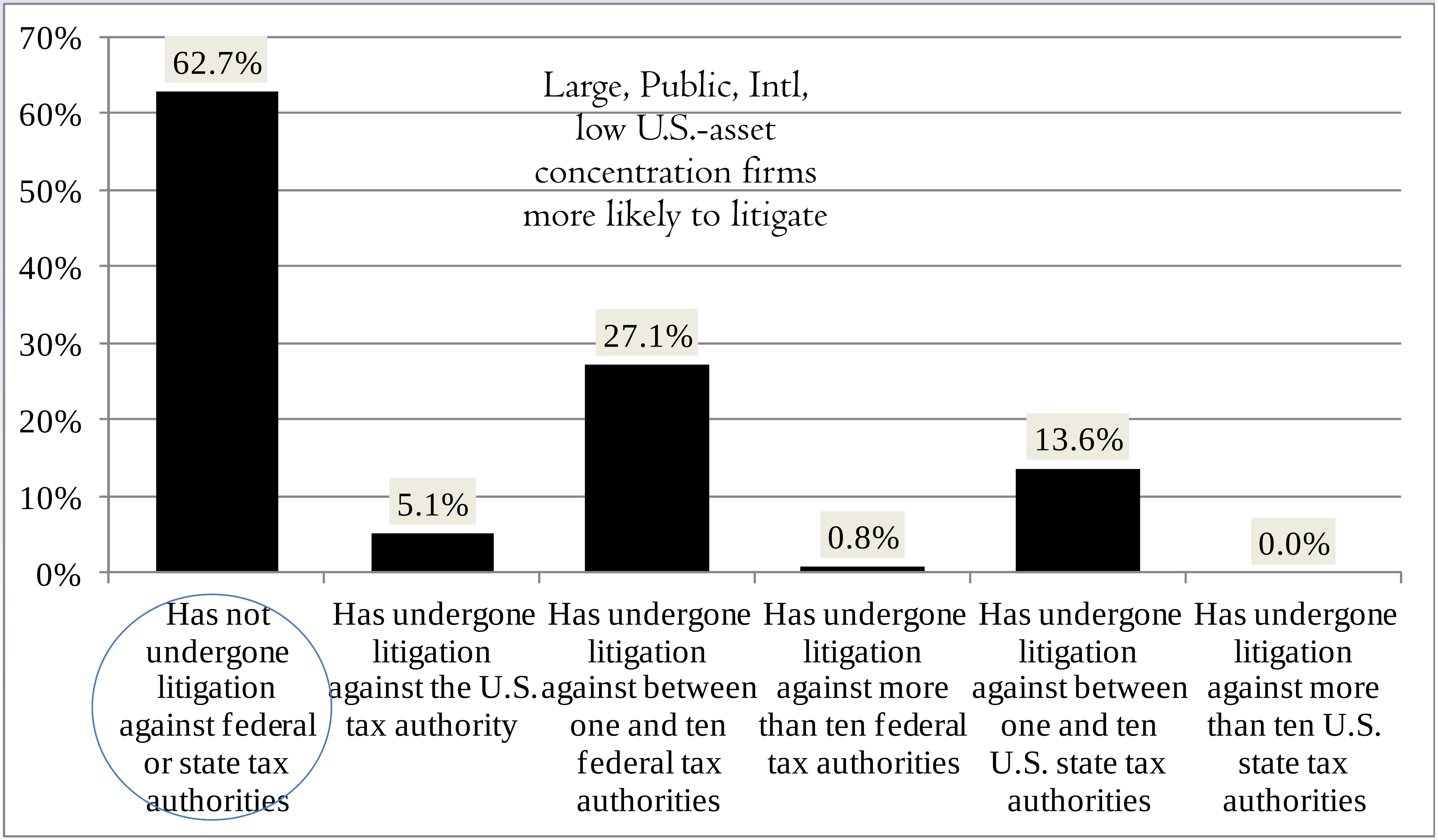
Large, Public, Intl,
low U.S.-asset concentration firms
more likely to be audited more

Tax Environment: Tax Litigation over Past 3 Years



Reputation Cost of Losing Tax Dispute w.r.t. TP (vs. non-TP) Issue