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)
Multinational Corporation = TaxAvoider

• “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.”

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.
Transfer Pricing: The Basics

- Better Strategy:

  **U.S. Parent (t=35%)**
  - 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.

  **Irish Subsidiary (t=12.5%)**
  - 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

Figure 1: The United States' Statutory Corporate Tax Rate is Increasingly out of Line Internationally

Source: OECD and Tax Foundation “Fiscal Fact” by Robert Carroll
Do Multinationals Avoid Taxes via Transfer Pricing?

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

Public data
- Consolidated ETR
- Foreign/Domestic ETR
- 10K: in what countries there are entities
- Geographic sales
Do Multinationals Avoid Taxes via Transfer Pricing?

Current Research:
- Blouin, Robinson, and Seidman (2012)

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

• Multinational corporations use transfer pricing to avoid taxes.

• But ...
Tax Authorities are Reacting

• “IRS Brings ‘A Team’ to Crush Transfer Pricing Abuse” – Forbes March 2012
• “OECD Urges International Tax Clampdown on Multinationals” – Reuters Feb 13, 2013

I pity the fool who abuses transfer prices!
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
Variation in the Tax Function

- MNCs’ approaches to taxes are not uniform
- Firms balance tax incentives with nontax & financial reporting effects differently
- 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?

Our Survey Data
- 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
Mfg firms more likely to employ experienced TP execs than non-mfg firms. No diff bw public/private, or large vs. small firms.
TP experience seems to have little to do with tax-motivated income shifting to tax havens.
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 is one of the least burdensome areas of tax.

Transfer pricing is no more or less burdensome than other areas of tax.

Transfer pricing is one of the most burdensome areas of tax.
Resource Adequacy for Transfer Pricing

My Company:

- □ Would benefit from investing additional resources in transfer pricing activity (51.6%)
- □ Has invested appropriate resources in transfer pricing activities for your needs (46.3%)
- □ Could invest less in transfer pricing activities (2.1%)
Transfer Pricing Compliance vs. Planning Resources

Shifting Resources towards Compliance, away from Planning

But firms that assess their TP practice on cash taxes spend a higher % on planning than firms with compliance goals.

Last 10 Years
Last 12 Months

But firms that assess their TP practice on cash taxes spend a higher % on planning than firms with compliance goals.
% of Transfer Pricing Compliance & Planning Outsourced

- Most Compliance & Planning done In-House

Large, Intl, low U.S.-asset concentration firms outsource TP work less frequently.

Compliance goal firms keep compliance work in-house more often than cash tax minimization goal firms.
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

Higher likelihood in non-mfg and NOL firms; not more prevalent in large, public, intl MNCs.
### Link Between Tax Minimization and Firm-Specific TP Attributes

<table>
<thead>
<tr>
<th>Correlation Coefficients</th>
<th>ETR</th>
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<tr>
<td>Low Cash Tax Goal</td>
<td>-0.22**</td>
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<td>Compliance Goal</td>
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<td>High International</td>
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<td>Assets (Logged)</td>
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<td>R&amp;D</td>
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<td>TP Experience</td>
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<td>NOL</td>
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<td>Underfunded TP</td>
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<td>Public</td>
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<td>Tax Haven Benefit</td>
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<td>OLS Results.</td>
<td>Dep. Variable: ETR</td>
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<td>Low Cash Tax Goal</td>
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<td>Adjusted $R^2$</td>
<td>51.9%</td>
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<td>$n$</td>
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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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Large, Public, Intl, low U.S.-asset concentration firms more likely to be audited more
Tax Environment: Tax Litigation over Past 3 Years

- 62.7% of Large, Public, Intl, low U.S.-asset concentration firms have not undergone litigation against federal or state tax authorities.
- 5.1% have undergone litigation against the U.S. tax authority.
- 27.1% have undergone litigation against between one and ten federal tax authorities.
- 13.6% have undergone litigation against more than ten federal tax authorities.
- 0.8% have undergone litigation against between one and ten U.S. state tax authorities.
- 0.0% have undergone litigation against more than ten U.S. state tax authorities.
Reputation Cost of Losing Tax Dispute w.r.t. TP (vs. non-TP) Issue

Most concerned: Public, non-mfg, large, intl, high TP uncertainty firms.