Chapter 12

International Taxation and Transfer Pricing

Discussion Questions

1. Tax neutrality means that taxes have no (are neutral in their) effect on business decisions. In other words, business decisions are driven by economic fundamentals instead of taxes. Such decisions should result in an optimal allocation of resources. However, taxes have the potential to divert this allocation of resources. Taxes are seldom neutral.

   Governments often use taxes for social purposes. This is not necessarily bad. For example, countries can use tax breaks to attract business investment, thereby promoting economic growth. Chapter 12 discusses harmful tax competition, a concern of both the OECD and EU. The concern is that some countries (tax havens) use taxes as an unfair competitive tool, depriving other countries of taxes needed to support their infrastructure and government services. Transactions are funneled through tax havens merely to avoid taxes; they have no real business purpose.

   Students should have fun debating whether this is good or bad.

2. The types of taxes discussed in the book are:

   a. *Income tax*. Tax bases and tax rates vary from country to country. The effective tax rate is what is important, not the nominal rate.

   b. *Withholding tax*. These are withholdings on interest, dividend and royalty payments to investors.

   c. *Value-added tax*. This is a consumption tax popular in Europe and Canada. The taxis levied on each stage of production or distribution based on the incremental value added at that stage. Companies that pay the tax in their own costs reclaim them later from the tax authorities. Consumers ultimately bear the cost of this tax.

   d. *Border tax*. This is a customs or import duty.

   e. *Transfer tax*. This is a tax on the transfer of items between taxpayers.

   The two most common taxes are the income tax and the border tax.

   Philosophies of taxation vary with the types of taxes, since ultimately the question is who pays and how much. In the case of income taxes, philosophies vary as to whether income earned outside the country's borders should be taxed (territorial versus worldwide).

3. Tax credits reduce a business entity's income tax liability dollar for dollar. The purpose of these credits in international taxation is to insure that profits earned abroad are not subject to double taxation. Accordingly, the country in which a parent company is domiciled will generally relinquish taxes on income earned abroad up to the amount of the foreign tax.

   Tax credits may fall short of their intended results because of how taxable income is defined under domestic and foreign tax laws. The treatment of expenses is a case in point. Under U.S. law, for example, business expenses attributable to foreign source income must be so allocated in determining the foreign tax credit limitation. Distortions occur when the deduction is not allowed in determining taxable income in the foreign country. The result is usually an overstatement of the total amount of taxes paid and excess foreign tax credits recognized. Additional distortions relate to national differences in defining income sources and timing differences in the recognition of income and expenses.

4.

Tax Rate System	Advantages	Disadvantages
Classical	Ease of administration	Double taxation of corporate income
Split Rate	Relief from double taxation provided at the company level	Higher tax rates on undistributed profits reduces the attractiveness of retained earnings as a financing source
Tax Credit	Relief from double taxation provided at the shareholder level	If tax credit is denied foreign shareholders, investing across national boundaries becomes less attractive

5. National differences in tax rates are indeed the least significant determinants of a company's effective tax burden. The key term here is effective. While statutory tax rates define a company's nominal tax burden, this seldom indicates its effective tax burden. Widespread differences in tax administration systems, allowable deductions, rates of depreciation allowances, tax credits, tax treaties, special tax incentives offered by foreign governments, and many indirect taxes (including deficient social overhead services in some low-tax countries) are some factors that affect real tax burdens on MNCs.

6. Student responses to this question will naturally vary. Some will argue that multinational operations abroad are merely guests of their national hosts. Given the visibility and political sensitivity of their positions, therefore, these firms should fully disclose their earnings picture to local tax authorities and pay whatever taxes are called for. However, others will argue that the competitive position of the multinational corporation will be jeopardized if it does not emulate the tax evasion practices of its local corporate peers. Furthermore, since business ethics are colored by the cultural and social fabric of each individual nation, it is presumptuous for a multinational to impose its domestic mores in an environmental context where they may not be appropriate.

7. Transfer pricing is a natural consequence of the decentralization of business organizations. Interactions between units of a decentralized system require the establishment of prices at which goods or services can be transferred among operating divisions. In a purely domestic setting, transfer pricing policy assures (a) a measure of performance that reflects a subunit's use of resources and (b) the optimal allocation of enterprise resources.

   Transfer pricing has assumed a more strategic role in management policy with multinational operations. Many MNCs use transfer prices to (a) reduce or hedge environmental risks, (b) develop favorable tax postures overseas, (c) support the competitive position of selected foreign subsidiaries, and (d) circumvent restrictions on fund movements between national boundaries.

8. (a) Transfer pricing objectives of a multinational company often produce results that directly conflict with the objectives of a foreign affiliate's minority shareholders. While the minority shareholders want maximum dividends, transfer prices may be designed to minimize the

affiliate's income and thus its ability to pay dividends. (b and c) Both domestic and foreign tax authorities are interested in enacting laws and regulations to counteract pricing techniques designed to minimize taxable income. Tax authorities want to claim their fair share of taxes. (d) Managers of foreign affiliates should be concerned because the manipulation of transfer prices destroys the usefulness of subsidiary profits as a measure of their performance. (e) Finally,

headquarters managers are vitally concerned with the acceptability of their transfer prices to governments where they do business. The cost of evoking the wrath of host governments who find transfer prices to be objectionable can far exceed any system-wide benefits that transfer prices can achieve. Headquarters should also be concerned if transfer pricing distorts performance measures because this can cause managers to behave dysfunctionally.

9. Considerations that complicate the administration of transfer pricing systems internationally include (but are not limited to) the following:

   a. Tax considerations -- to minimize its global tax bill, a multinational entity might raise (lower) the transfer prices of goods shipped from affiliates located in low-tax (high-tax) countries.

   b. Tariff considerations -- to minimize foreign tariffs, a firm can lower (raise) transfer prices on goods shipped to high (low) tariff countries.

   c. Competitive considerations -- a local affiliate's competitive position can be improved if it is charged low transfer prices on goods imported from a parent or manufacturing affiliate.

   d. Foreign inflation -- a parent company may raise transfer prices on goods shipped to an affiliate located in a highly-inflationary country to minimize local funds subject to that country s inflation.

   e. Foreign exchange risk -- to minimize foreign exchange risk, a parent may raise transfer prices to an affiliate located in a devaluation prone country to move exposed assets to a more stable environment.

   f. Performance evaluation considerations -- to evaluate the performance of a foreign cost (service) center, a parent company might use transfer pricing to give the affiliate a revenue stream. This would enable the parent to evaluate the affiliate with traditional profitability measures.

10. Transfer prices are generally based on market price or some variant of cost. Among the advantages of using market prices are that they (a) encourage the efficient allocation of corporate resources, (b) provide meaningful criteria for performance evaluation, (c) assist in identifying profitable and unprofitable units, and (d) are easy to defend as arm's-length prices to host governments. Cost-based transfer pricing systems also have many advantages in that they are (a) simple to use, (b) based on readily available data, (c) easy to verify before tax authorities, and (d) easily routinized.

    The overall competitive and financial position of the MNC is a major consideration in international transfer pricing policy. Accordingly, a cost-based transfer pricing system is best from the viewpoint of headquarters management. The flexibility afforded by cost-based transfer prices (i.e., transfer prices can be adjusted by changing the cost base itself or markups on cost) is especially important in helping MNCs to cope with the many environmental risks and constraints which affect their international affairs. However, while cost-based transfer pricing systems promise greater flexibility, increasing governmental scrutiny of transfer pricing decisions will undoubtedly limit their flexibility.

11. An arm's-length price is one that would have been paid to an unrelated party for the same or similar goods under identical or similar circumstances. The United States is not alone in mandating that international transfer prices be based on an arm's-length price. As the chapter points out, many countries have enacted legislation giving their tax authorities the right to

reallocate gross income, deductions, credits or allowances to prevent tax evasion or to more clearly reflect the proper allocation of income.

While the notion of an arm's-length price provides a conceptual foundation on which to base transfer prices, it is less than definitive in practical application. Accordingly, application of the arm's-length principle is far from uniform internationally. Surveys of existing corporate transfer pricing practices reveal a variety of pricing modes often based on professional judgment and approximation.

12. Advance pricing agreements (APAs) are a negotiated agreement between a multinational and a taxing authority on an acceptable transfer pricing methodology. The APA is binding on both parties for a fixed period of time. The main advantage of an APA is that transfer pricing conflicts can be eliminated or reduced, saving time and money for both the multinational and the taxing authority. The certainty of transfer pricing treatment makes long-term strategic planning easier for the multinational. The disadvantage is that the parties are locked in to the agreement, which can be a problem if circumstances change. Of course, time and effort are also needed to achieve the APA.

Exercises

1. At first blush, Company X promises the better performance as it has a higher pre-tax income. However, a closer examination shows that both companies promise identical after-tax returns. A return on sales of 12.0% yields after-tax earnings of $72 million (12% X $600 million) for both companies. Comparative income statements based on the ratios provided are ($ millions):

	Company X	Company Y
Sales	600	600
Operating expenses	480	528
Pre-tax income	120	72
Income taxes	48	-0-
Net income	72	72

Thus, it appears that Country X has a 40% income tax rate. Country Y's indirect taxes are buried in operating expenses. Moral : when comparing company investment performance, focus on after-tax returns.

2. Company X is the better investment because the investor in Country Z is probably not entitled to a foreign tax credit for indirect taxes paid. This is illustrated below.

	Country X	Country Y
Pre-tax earnings	$120.00	$72.00
Income tax (40%)	48.00	-0-
After-tax earnings	72.00	72.00

Country Z’s investment income:

Dividends	36.00	36.00
Gross-up for foreign taxes paid (36/72 x 48)	24.00	-0-
	60.00	36.00
Income tax (35%)	21.00	12.60
- Foreign tax Credit[a]	(24.00)	(-0-)
Income tax	-0-	12.60
After-tax return	36.00	23.40

[a] Excess tax credits can be carried back 1 year and forward 10 years.

3. There are no taxes paid on these transactions. China and Australia tax corporate income (Exhibit 12-2) but the subsidiaries there have no profits. The entire profit is in the Cayman Islands subsidiary, where there is no corporate income tax.

   As discussed in the chapter, the Cayman Islands subsidiary would seem to be a brass plate subsidiary with no real work or employment attached to it. Such subsidiaries lack substantial activities and merely funnel financial transactions through the tax haven country to avoid another country s taxes. The company involved is doing nothing illegal. The issue for the taxing authorities of Australian and China is whether the company is paying its fair share of their respective national taxes. These taxing authorities might tax passive income or adjust the transfer pricing arrangement so that they capture some income tax. These are the implications for the company and the taxing authorities involved.

4.

Subpart F foreign base company income =	$4,000,000
$4,000,000 x U.S. tax at 35% =	1,400,000
- Tax credit for foreign taxes paid ($4,000,000 x 17.5%)	700,000
Net U.S. taxes due	$ 700,000

Students must refer to Exhibit 12-2 for the U.S. tax rate of 35%.

5.

Value added including tax (4,000 – 2,400)	=	1,600
Value added excluding tax (1,600 ÷ 1.175)	=	1,362
Value added tax (17.5% x 1,362)	=	238

6.

Classical System

Corporate income	SEK1,500,000
- Income tax (28%)	420,000
= Net income	1,080,000
Dividend	SEK540,000
Income to shareholder	SEK540,000
- Personal income tax (40%)	216,000
=Net income	SEK324,000

Total taxes paid:

Corporate	SEK420,000
Individual	216,000
Total	SEK636,000

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