Transfer Pricing in Multinational Corporations: An Integrated Management- and Tax Perspective

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Abstract

Transfer prices play a central role for both managerial accounting and tax reporting purposes in vertically integrated firms. Common to these purposes is that transfer prices ultimately determine the distribution of reported income across different segments (divisions) of the firm. The managerial accounting literature has long viewed transfer prices as an instrument for coordinating the production and sales decisions of different business segments. The tax-oriented literature on transfer pricing, in contrast, has largely viewed the transactions between business segments of the firm as given. The major focus in this literature has been on how a firm can minimize its worldwide tax liability within the confines of the arm’s-length standard. In this article, we take an integrated view of managerial and tax considerations by analyzing how the optimal internal transfer prices depends on the admissible arm’s length price and the applicable tax rates.

1. Introduction

In vertically integrated firms, transfer prices play a central role for both managerial accounting and tax reporting purposes. Common to these purposes is that transfer prices ultimately determine the distribution of reported income across different segments (divisions) of the firm. In terms of the stated objective of transfer pricing in Multinational Corporations (MNC’s), respondents in a 2003 survey by Ernst & Young cite both “maximizing operating performance” (73%) and “optimizing tax arrangements” (68%) as either as the “main” or an “important” priority.1

The managerial accounting literature has long viewed transfer prices as an instrument for coordinating the production and sales decisions of different business segments. Transfer prices are intended to provide divisional managers with relevant information about the cost and profitability of intra-company transactions. Since performance measures for divisional managers are frequently based on the profits of the segments they manage, transfer prices have a key resource allocation function in facilitating and incentivizing the transfer of goods and services across divisions. From that perspective, the objective of transfer pricing is to enable a decentralized firm to achieve its full profit potential.

1 See Ernst & Young (2003). The same survey suggests that among German parent companies some 48% of the respondents view transfer pricing primarily as a tax compliance exercise, while 36% of the respondents believe that “achieving managerial/operational objectives has a stronger influence on determining transfer prices than satisfying tax requirements or some other influence.”
The tax-oriented literature on transfer pricing, in contrast, has largely taken a monolithic view of multinational firms. Accordingly, the internal resource allocation function of transfer prices has played a subordinated role. Instead, the transactions between business segments of the firm are viewed as given and the major focus in this literature has been on how a firm can minimize its worldwide tax liability within the confines of the arm’s-length standard that is applicable in most OECD countries (Eden, 1998).

In order to address both the managerial and the tax minimization objectives of transfer pricing, some MNC’s adopt a system of “two sets of books.” Accordingly, the transfer prices used for internal performance- and profit measurement are “decoupled” from the ones used for tax reporting purposes. It appears that, as of now, the majority of multinational corporations prefer a unified approach, that is, a single set of transfer pricing records (Ernst & Young, 2003). The advantages of maintaining a single set of books pertain to the reduced cost of recordkeeping and the consistency between internal and tax reports. The consistency aspect is obviously relevant with regard to simplifying the planning decisions of business segment managers. Perhaps more importantly, a single set of books avoids the potential for disputes with tax authorities that can arise when internal valuations for specific transactions differ from the ones used for tax reporting purposes and tax authorities can subpoena the firm’s internal records.

While a single set of transfer prices is arguably still the most prevalent practice in most MNC’s, a growing number of corporations appear to question the economic relevance of prices that are determined solely to minimize the firm’s overall tax liability while remaining compliant with the arm’s length standard. Questions of economic relevance arise in part since in practice the criterion of a “comparable uncontrolled price” almost always requires references to transactions undertaken in the past between unrelated parties. Studies by Wilson (1993) and Springsteel (1999) suggest an increasing trend towards decoupling. Specifically, Springsteel (1999) reports that 77% of respondents in a “best practice” group now operate with two separate sets of books, compared to only 25% of respondents outside that group.

Managerial accounting textbooks typically acknowledge the crucial tax dimension of transfer prices. At the same time, the discussion of the most prevalent transfer pricing methods in practice, in particular, cost-based, market-based and negotiated transfer pricing, typically ignores tax considerations. This omission is usually justified with reference to the possibility of decoupling. A conceptual issue with this approach is that the tax-admissible transfer price is itself part of the economically relevant valuation of the transaction in question. Tax reporting for a particular trans-

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2 See, for instance, Harris and Sansing (1998). One of the respondents in the Ernst & Young (2003) survey articulates this point in the following manner: “Part of the problem is that each operating group is compensated in accordance with their respective country’s profit and this may conflict with transfer pricing prescriptions in the jurisdictions.” Along similar lines, another respondent states: “We have overcome the difficulties (in incentives and performance measurement) by the accounting methods used for management incentives, i.e. bonuses. We run two sets of books; one for statutory accounting and one for management reporting.”

3 See, for instance, Horngren et al. (2008) and Zimmerman (2006).