Some 25 years ago, Klaus Macharzina was Professor of Accounting at the University of Lancaster. One of his possibly more onerous tasks was to supervise my doctoral thesis entitled Transfer Pricing in the Corporate Environment. His patience, sound advice and genuine encouragement contributed greatly to a successful defence of the thesis. It is therefore only appropriate that the interest which he nurtured in transfer pricing should be the subject of my contribution to this volume. My abiding hope is that it is not covered in ‘red inked’ comments after it is read.

1. Introduction

Global market imperfections are created by host government policies to attract and retain multinational company investment (Leitch et al. 1992). Multi-National Enterprises (MNEs) are therefore provided with strong incentives to adjust their international transfer pricing (ITP) policies to secure the benefits offered by host governments. MNEs would not be acting rationally in economic terms and would fail to create wealth for their shareholders if their ITP policies did not recognise the opportunities created by market imperfections (Borkowski 1996). Comparative advantage is afforded MNEs by host governments adopting differential tax regimes and regulations regarding international transactions. Carefully constructed ITP policies may therefore ensure an optimal geographic distribution of profits to minimise global tax liability (Klemm et al. 1995). It is estimated that more than half of all trade among advanced nations takes the form of cross-border transactions between related parties (Ernst & Young 1997).

The aim of this study is to examine MNE capability to adopt ITP policies which result in minimisation of global tax liability. A model is developed which incorporates actual differential income and with-holding tax rates, import duties and foreign tax credits, where appropriate. The sensitivity of parent and subsidiary after tax incomes to differing ITP policies is examined using the tax rules of the USA, Taiwan and Greece simultaneously. By means of the model, the potential benefit of transfer price manipulation is gauged. The findings suggest that the direction of the trade has little impact on parent after tax net income although the forms of tax in the host country is of some influence. The primary effect of ITP changes occur at the subsidiary level where net income after tax fluctuates dramatically.

The paper follows a conventional structure of first reviewing the literature in terms of the evidence of ITP capability to shift income in order to minimise global tax liability. The modelling approach is then introduced and the model is articulated. The findings are subsequently examined and the paper concludes by addressing the issues for future re-