Transfer Pricing in the 1990s

TAX AND MANAGEMENT PERSPECTIVES

Roger Y.W. Tang

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To
Professor Robert H. Raymond
A Good Friend and an
Outstanding Educator

Preface

Transfer pricing is a dynamic and multidimensional topic that has captured the attention of academicians, corporate executives, and tax authorities for many decades. The issues of transfer pricing are very complex, and the stakes are extremely high because more than 40 percent of international trade is trade between related entities. More than $360 billion of U.S. foreign trade in 1992 represents intrafirm trade.

In the last fourteen years, I have published two books and many articles on transfer pricing. During the same period, I have also spoken to many corporate executives and government officials on topics related to transfer pricing and intrafirm trade. Many issues in this area remain controversial and unsolved. The focus of debates has shifted, however, from domestic to tax and multinational issues.

I hope to accomplish three objectives with *Transfer Pricing in the 1990s: Tax and Management Perspectives*. First, I will discuss recent changes in transfer pricing regulations introduced by the U.S. government and its major trading partners. Many of these new regulations may have significant implications to the management of a multinational transfer pricing system. Second, I want to provide readers with current information on U.S. transfer pricing practices. The information was obtained from a survey done in 1990. Another objective is to compare the current practices with those of an earlier study done in 1977 and published in *Transfer Pricing Practices in the United States and Japan* by Praeger in 1979. Similarities and differences between findings from the two studies will be explained.

Many corporate executives of Fortune 500 companies contributed their time and experience generously to this research. I would like to thank them for their cooperation and contribution. My appreciation also extends to many other individuals who provided valuable suggestions and assistance for this study. Professor Herbert L. Jensen and Beverly Eby reviewed the manuscript. Barbara Peacock provided skillful typing of the book.

I am grateful to all the people at Greenwood Publishing Group for their encouragement and support. They include Eric Valentine, publisher of Quorum Books; Meg Fergusson, production editor; and JaNoel Lowe, copy editor. Finally, this book is dedicated to Professor Robert H. Raymond who taught me the essentials of international accounting.

Roger Tang
Kalamazoo, Michigan
September, 1992

Transfer Pricing in the 1990s

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Introduction

Transfer pricing is the process for determining the prices of goods and services transferred among organizational units. The entities involved can be departments, divisions, or related companies of a corporate family. In the past, many authors have recognized the significance and difficulties of transfer pricing. For example, in an earlier edition of his popular textbook, Horngren (1977, p. 679) stated that "transfer pricing information affects many critical decisions concerning the acquisition and allocation of an organization's resources, just as prices in the entire economy affect decisions concerning the allocation of a nation's resources." Eccles (1985, p. 1) commented that "the transfer pricing problem is a difficult and frustrating one. Although there has been substantial interest in this problem among academics, many managers regard it as unsolved and unsolvable."

In a multinational context, the problem takes on new dimensions such as international taxation, tariffs, foreign currency translations, and the like. These dimensions (or environmental variables) of transfer pricing may have enormous control implications for a multinational company.

Because of the importance and complexity of the transfer pricing problem, many issues in this area have been discussed extensively in business and economic literature. Most of the studies, however, deal with the theoretical merits of various pricing methods. A list of major proposals on proper transfer prices can be seen in Table 1.1. These proposals range from doing away with transfer pricing under most circumstances to using different prices for different purposes. However, the arguments put forward by these authors are often inconsistent and sometimes even contradict each other.

Table 1.1
Major Proposals on Proper Transfer Price(s)

I. Do away with transfer price under most circumstances: Wells (1968, 1971)

II. Cost-oriented methods:
  A. Economic cost-oriented methods:
    1. Marginal cost: Hirschleifer (1956); McMurray (1961)
    2. Opportunity cost: Samuels (1965); Onsi (1970); Holstrum and Sauls (1973)

  B. Accounting cost or cost-plus methods:
    1. Incremental cost: Goetz (1967)
    2. Standard variable cost plus the cost contribution margin: Benke and Edwards (1980)
    3. Cost plus some allowance for profit: Gordon (1970); Crompton (1972); Vendig (1973)

III. Market-oriented methods:

  Market price: Cook (1955); also proposed by Hirshleifer (1956) under some circumstances

IV. Negotiated price: Dean (1955); Li (1965); Haidinger (1970); Fremgen (1970); Shaub (1978)

V. Contribution approach: Schwab (1975)

VI. Dual pricing (the use of two transfer prices): Drebin (1959); Greer (1962); Edwards and Roemmich (1976); Cassel and McCormack (1987)

VII. Mathematical programming:

  A. The decomposition procedure: Dantzig and Wolfe (1963); Baumol and Fabian (1964); Charles, Clower and Kortanek (1967); Hass (1968); Love (1980)
  B. Linear programming: Petty and Walker (1972)
  C. Goal programming: Bailey and Boe (1976); Merville and Petty (1979)
  D. Other methods: Rutenberg (1970); Manes and Verrecchia (1982); Emmanuel and Gee (1982); Kant (1988)

VIII. Different prices for different purposes: Bierman (1959); Lococo (1983)

Source: Compiled by the author. An earlier version of this table was shown in Tang (1979, p. 10).

Note: The years in parentheses represent the years the authors' articles or books were published. Complete references can be found at the end of Chapter 1.

The crucial fact is that a single transfer price will meet all the needs of an organization only rarely. The appropriate transfer price depends on the economic and legal circumstances and the decision at hand (Horngren 1977, p. 689). This is equally true in international transfer pricing. As observed by Granick (1975, p. 39), "not only do systems of transfer pricing within large organizations differ among industrial nations, but . . . no single system is best in all managerial environments." The implication is that situation-specific answers may be necessary to solve many of the problems facing management of multinational companies. One way to find out these answers is to conduct systematic long-range monitoring and analysis of transfer pricing practices of multinational companies. In addition, greater emphasis should be placed on the development of transfer pricing strategies that take the constantly changing environmental variables into consideration.

To respond to these needs, the author undertook a series of studies of transfer pricing practices in four industrialized nations (the United States, Japan, Canada, and Britain) in the 1970s and early 1980s. The result of these studies were published in Tang (1979, 1981).

The need for effective transfer pricing systems remained strong throughout the 1980s and in the early 1990s. The focus of transfer pricing has shifted gradually, however, from domestic to international and tax issues. Many legislative changes implemented in the 1980s may have enormous ramifications for tax planning and the management of a multinational transfer pricing system in the future. In 1990, the author conducted another transfer pricing survey of the Fortune 500 companies. The findings and results of that study will be presented in this book.

In the remainder of this chapter, we will discuss the following:

- Types of intrafirm transactions in a corporate environment,
- Megatrends and the significance of intrafirm transactions in international trade, and
- The need for a multidisciplinary approach to solve many problems in transfer pricing.

An overview of the book will also be provided in the last section of the chapter.

INTRAFIRM TRANSACTIONS IN A CORPORATE ENVIRONMENT

To comprehend the magnitude and complexity of the transfer pricing problems, it is necessary to understand the nature of various forms of intrafirm transactions. As shown in Figure 1.1, these transactions cover a wide variety of transfers between divisions within a firm or between related units of multinational companies (MNCs). These transactions include transfers of goods and services, transfers or uses of intangible property, uses of tangible property loans, and intrafirm financing and other cost-sharing arrangements. Related transfer prices for these intrafirm