Value Management and Transfer Pricing in an Integrating World - a Trend towards Convergence and Diversity

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1. Introduction: Global Corporations and Comparative Institutional Advantages

The globalization of the markets has meddled with the strategies of international corporations. On the one hand, technological advances in telecommunications and transportation are developing at lightning speed. Data can be transferred to virtually any place while costs are continually declining. Fast paced information exchange is bringing the international market place ever closer together. Individual regions and countries boast their individual strengths to compete successfully. On the other hand, the international financial markets have gained tremendous importance over the past twenty years, thereby achieving increased integration of corporate functions and operating levels. Players at the financial markets impact corporate operations via friendly and/or hostile takeovers as well as through corporate acquisitions, which are financed with borrowed money. Corporate management on the other hand has to stand up to mergers and acquisitions, stock buy-backs and restructuring at the financial markets while keeping an eye on the markets' benchmarks.

New challenges in the global market place are forcing corporations to re-evaluate traditional ways of doing business. Bartlett and Goshall (Bartlett, Goshall, 1990) discussed the tendency towards transnational corporations and integrated networks with respect to corporate governance. These models range from highly centralized to mostly decentralized conglomerates. Multinationals often feature a highly decentralized structure with respect to responsibilities and decision making processes. This enables them to act independently of the directives of the domestic parent company back home when they operate abroad. This model equips subsidiaries with the flexibility to respond swiftly to local market conditions. In contrast, some global corporations concentrate their decision making, know-how and resources at the head office of the parent company back home. This model restricts the affiliates' scope and ability to respond quickly. While this model allows for

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quick and cost effective manufacture of new products and systems, the subsidiaries' local know-how and competence is not effectively utilized.

The creation of global networks highlights their compatibility with the objectives of value management. Transnational corporations pool the resources of corporate headquarters and their subsidiaries. Costs and proceeds are optimized to gain a competitive advantage. Fundamental research is centralized to protect core competence; the same is true for financial control. Additional skills and resources are not centralized at headquarters back home but rather at the local level abroad. Applied research is thus outsourced and relocated to regional markets. Furthermore, this will bring about the development of manufacturing plants in low-wage countries such as China, Mexico, Singapore and/or central and Eastern Europe. Again for countries such as Germany, Japan and the U.S.A., it may be advantageous to pool know-how in order to develop and introduce new technologies. Efficient local subsidiaries abroad are revamped into international production sites. Innovative development labs in select countries assume the role of global output centres for specific product and process engineering. The 'global factory' commands a higher percentage of intra-corporate trade in world trading. This trend is also reflected in the increased percentage of preliminary products and semi-finished goods.

The result is a highly complex network of spread out but highly specialized skills and assets. Individual subsidiaries are able to focus on core competence and effectively market their respective competitive advantage. Site selection is highly dependent on three factors, which should be well balanced: market access, available skills and a cost, tax and incentive package.

Spreading corporate activities is a cost effective way to make use of regional differences in cost with the ultimate objective to reduce overall cost for the conglomerate. In contrast to independent subsidiaries, the coordination and specialization of activities will yield strategic advantages. Losses are balanced with profits gained in the markets of other countries. Furthermore, strategic alliances with unaffiliated companies can prove to be an additional advantage. That's because the high cost associated with product development and operations compels technological transfer and know-how. In this context, license revenues constitute a significant source of income.

Globalization of the entire value added chain thus represents a key component of the international production networks. Purchase and supply systems, organization of research and development, application of new technologies, in fact the entire production and distribution systems are all integrated. Skilled labour, raw materials, semi-finished products, knowledge and subcontractors are utilized wherever a regional competitive advantage can be fully exploited. This facilitates functional specialization and the development of clusters at specific sites.

Value added activities are assigned based on the most economical expenditure and investment incentives offered by individual sites. Domestic production at Volkswagen, for instance has dropped to less than 44 percent. The trend towards the ‘global product’ is evident not only in automobile manufacturing. Different models are manufactured with flexible manufacturing technology, which require only a limited number of assembly parts. General Motors has cut by more than half the number of platforms. We need to bear in mind however that Opel has assumed responsibility for some of these parts. Within the global network, the individual subsidiary can become the centralized entity responsible for technology, production and distribution. Localized specialization of individual functions and processes within the value added chain creates tremendous potential for value appreciation. Considering that global corporations have an advantage in obtaining low priced capital at the international financial markets, this potential is further augmented.

These developments raise interesting questions. Corporations must respond to the pressure of change. This naturally affects international institutions as well since corporations do not operate in a vacuum. First of all, different countries generate their own institutional infrastructure, which reflects historic and cultural idiosyncrasies. This raises the possibility that countries may derive comparative advantages from their institutional infrastructure (Hall, Soskice 2003, v). Furthermore, it is virtually impossible for countries to try to circumvent the competition for most profitable site. Within the global framework, the selection of the most competitive site means scrutinizing and challenging the national set-up. It affects virtually all realms of politics. We will analyze the reciprocal process of change at the corporations and institutions further. The approach to comparative capitalism by Hall and Soskice appears promising. We will examine global trends towards achieving standardization and look at remaining national differences.

At this point, we will focus on the impact of value management on corporate transfer pricing. Multinational corporations utilize transfer pricing strategies to control the transaction of goods and services among group-related corporate subsidiaries. In addition to the standard function of controlling resources and increasing performance at the parent/subsidiary level, the reduction of overall tax liabilities for the entire conglomerate is becoming more important (Wei, Andreosso-O’Callaghan, von Wuntsch 2007). The arena of economic activity with respect to management is again limited by the legal and cultural constraints of the individual countries. Although the trend is towards standardization of international norms and management styles, it is worthwhile to highlight the remaining differences.

2. Trend towards Shareholder Orientation and Value Management in Asia and Europe

The creation of multi-national production networks is a by-product of the formation of the global financial markets. Since the 1980s, financial globalization has accelerated. This is due to the deregulation of the domestic securities and capital markets, the liberalization of borderless financial transactions and new technologies. Together these have enabled economic activities to become global in that they can take place anywhere, anytime while spanning different time zones. Not only has this intensified inter-corporate competition, it also increases competition between different types of capital investments. Hence corporate management increasingly relies on value management.

"Creating Shareholder Value" by Rappaport represents an important contribution in the debate surrounding shareholder orientation in corporate management. In his book, Rappaport emphasizes that creating shareholder value is the prime responsibility of a market economy.

> "The idea that management's primary responsibility is to increase value has gained widespread acceptance in the United States since the publication of `Creating Shareholder Value´ in 1986. With the globalization of competition and capital markets and a tidal wave of privatizations, shareholder value rapidly is capturing the attention of executives in the United Kingdom, continental Europe, Australia, and even Japan. Over the next ten years shareholder value will more likely become *the* global standard for measuring business performance."
> Alfred Rappaport, 1998: 1

Central to the theoretical discussion is the question of how to adequately measure performance. Accounting-based earnings and methods are inconsistent with the shareholder return objective. From an economic point of view, we are dealing with a new perspective, one which is focused on increasing corporate value. Shareholders measure success in terms of increased dividend yield. The assumption is that returns are comprised of dividend pay outs and added value of a particular stock. From a shareholder's perspective, added value consists of the difference between the purchase price and the realized sales price of a particular stock. The return thus represents interest on invested capital. In this model, sound financial management commences only when the interest yield of invested capital surpasses the expectations, i.e. the opportunity costs of the investor.

In value based management, yield expectations of the shareholders are the decisive comparable. The yield entitlement in away represents the calculated rate of return of the investor. The calculated rate of return is based on the weighed average cost of capital, which consists of the cost of equity and the cost of debt. The key term ‘cost of equity’ contains three components (von Wuntsch *et al.*, 2005: 33): base yield (risk free yield), a general market risk premium and the systematic risk (beta factor).

A corporation’s weighted average cost of capital represents the standard measure for corporate investment projects. Based on this corporate point of view, if operating cash flow exceeds the weighted average cost of capital, then the result is an increase in the value of the corporation. The reverse scenario would lead to a devaluation of the corporation. This point of view assumes that value based management results in efficient allocation of capital.

The objectives are clearly defined:

- Alignment of planning and controlling towards increased shareholder value
- Explicit evaluation of strategic investment decisions with respect to development of the company value.

Within the last ten to twenty years the trend towards value-based management has gained momentum in many corporations throughout the world (Copeland *et al.,* 2000: 11). This development originated in the U.S. in the 1980s and spread throughout Europe and Asia in the 1990s. In essence, we can highlight three elements:

- Increased importance of institutional investors
- Added value orientation as a protective measure against hostile takeovers
- Globalization of product markets.

First: Ownership of widely held stock has changed. Institutional investors and private shareholders own widely held stocks. Even in Germany and particularly in Japan there’s been a significant increase in institutional investors. Next to domestic funds, American pension funds dominate with respect to international exposure. Siemens and Veba make an excellent case in point. Between 1993 and 1999 Siemens has registered an increase in institutional investors from 15 percent to 45 percent. At Veba, this increase has jumped from one percent in 1987 to 71 percent in 1999.

Institutional investors are not tied to individual corporations when deciding on their investment options. Instead their concern is purely financial, based on rate of returns and degree of risk. According to a survey commissioned by the Deutsche Bundesbank[1] the average investment duration spans approximately one year. Competition between investment funds intensifies the pressure on corporate management. Sanctions or penalties range from under-allocation, the complete pull-out of capital all the

[1] For a more detailed analysis cf.: Deutsche Bundesbank (2001, 46 *et sqq.).*

way to rewards and incentives like over-allocation in portfolios. In their buy and sell decisions, fund managers generally pay attention to the quality of corporate governance.

Second: The danger of a hostile takeover is minimized by focusing on a corporate policy, which is based on shareholder interests. According to Alfred Rappaport, offers to acquire shares and which are directed at shareholders of the target company represent the driving force of a capital market based corporate policy (Rappaport 1998: 1). Governance of widely held stocks by institutional investors with an international focus results in greater transparency with respect to selling to hostile takers.

German managers have yet to get used to the idea to make hostile takeovers part of their modus operandi. This development came about as a result of the increased importance of institutional investors, and is accompanied and augmented by all corresponding changes. German banks[2] in particular have altered their previous strategy based on the model of supervision via large industrial concerns in favour of investment banking. Mergers and acquisitions consulting, which is a key component necessitates that banks operate more independently of industrial concerns.

The late 1990s featured a steady stream of rumours pertaining to hostile takeovers of German corporations. (Veba, Beyer, Schering, Siemens, DaimlerChrysler, Deutsche Bank etc.). A case in point is Hoechst. Foreign shares of equity capital at Hoechst grew from 33 percent in 1982 to 50 percent in 1996. During this time span, the percentage of corporations and institutional investors rose as well. By 1996, the U.S. institutional investor "The Capital Group" was already the third largest shareholder of Hoechst. Pharmaceuticals and the life sciences industry experienced consolidation and restructuring in the 1980s, a trend that intensified during the 1990s. This caused a wave of takeovers with catastrophic results for the conglomerate structure of Hoechst. When Jürgen Dormann assumed the position of managing director in 1994, he initiated a stronger shareholder based orientation. With the new focus on value added management, performance based diversification was eliminated in favour of concentrating on core business to improve earnings. In essence, diversified corporations deal with a proportionally larger danger of a hostile takeover and the danger of being traded below the sum of all its parts. That is because the larger the corporation, the larger the sum of cross subsidies for unprofitable sub entities from profitable ones. The effective market value thus is assumed to be below the sum of the potential value of all the individual subsidiaries, i.e. the conglomerate discount.

Third: Capital market orientation is especially pronounced when sectors are exposed to international product competition (Höpner 2003: 82 et sqq.*).*

[2] For a more detailed analysis cf. Monopolkommission (1998: 102 *et sqq.).*

Increased competition in the 1990s has significantly raised the market risk for German companies. The emphasis on shareholder orientation is a direct response to the heightened pressure of competition. The globalization of companies typically starts out with the globalization in sales. Therefore, the development of production sites abroad or the acquisition of companies operating in the target country is often related to the trend of the commodities trade. Intermediate production levels abroad including actual production may include local distribution, warehouse or service sites.

These developments also mark important institutional changes in different countries. A perspective on institutional change can be outlined and applied to Germany and Japan. We can view the German and Japanese models of capitalism as systems of incentives and constraints. In contrast to the U.K. and the U.S.A. neither model is considered market based in the classic liberal sense. Both Germany and Japan are headed in that direction, i.e. approaching the model of shareholder value. The control that banks exert over corporations has diminished, especially in Germany. German corporations used to be highly dependent on their main banking institution. The bank would provide financing and at the same time would also hold a stake in the corporation itself. The highly lucrative investment banking system is progressively incompatible with the German main bank based financial system. That is why German banks have relinquished their industrial shares significantly since the late 1990s. Corporations which are listed on the stock exchange have begun to be more dependent on equity investors (Vogel 2003: 317), who are more driven by the markets.

The restructuring of the bank-based financial system in Japan progressed along different lines. After World War II, administrative guidance developed into a system of informal relations between regulators and financial institutions. This involved a mix of formal restrictions and unwritten instructions on bank lending and branching policy. One was the practice of issuing new shares at par value rather than market value. Additionally, the state and leading financial institutions regulated access to capital markets through the approval of size and timing of new bonds (Vitols 2003: 255). As a result of the Asia crisis of 1997 and 1998 the pressure to deregulate intensified and with it the pressure to establish a politically independent central bank.

Although Japanese corporations have eased their dependence on bank loans, new networks between banks and corporations have emerged. This holds true especially for small and mid-size companies. Banks continue to hold large industrial shares. The sale of these shares typically occurs with prior consultation with the companies involved. If a corporation incurred losses due to a financial crisis, it was forced to shift back from equity financing to borrowing (Vogel 2003: 319).

The shareholder value based way of doing business is much less developed in Germany and Japan than it is in the Anglo-Saxon countries. In comparing Germany and Japan, this new trend seems to be gaining more ground in Germany. An important reason for that might be, that the EU gives greater urgency to corporate adoption as firms fight off new competitors in their home markets and move into foreign markets (Vogel 2003: 330).

In contrast to the liberal market economies such as North America and Great Britain, Germany, Japan and South Korea are generally viewed as coordinated market economies based on their institutional framework. Coordinated market economies can be further subdivided into industry-based coordination as in Northern Europe and group-based coordination (Hall, Soskice 2003: 34). In Germany, companies often cooperate within the same industry in the areas of training and technology transfer. Business associations and trade unions are organized along industry-specific skills and wage coordination. By contrast, business networks in Japan are built on families of companies (keiretsu) with interconnections across industries. Therefore, workers are encouraged to acquire firm or group specific skills. Workers are motivated to invest in skills because large firms offer life-time employment. While liberal market economies tend to concentrate power in the political executive, coordinated market economies are rather governed by coalitional regimes. Fluid market settings can enhance investment in different kind of assets or industries. By comparison, investment in specific industry assets or industries is more encouraged in coordinated market economies.

The inclusion of China into this assessment poses a challenge from the point of view of comparative institutional advantage. This concept needs to be inclusive of all the varieties of market systems. Notwithstanding the idiosyncrasies of the Chinese way, it is clear that the Chinese focus has been on the economy. The Chinese emphasis on economic success as manifested since the late 1970s represents a shift towards an efficiency approach, very much in the sense of Max Weber (Weigelin-Schwiedrzik 2007: 9). The new law of ownership enacted on October 1st, 2007 for the very first time ever provides for equal protection of private, state and collective ownership.

In accordance with WTO protocol China agreed at the end of 2001, to put foreign banks on a par with Chinese domestic banks. Although China has yet to fully comply, China is increasingly opening up her financial sector. This policy of liberalization is evident at different levels (Schüller 2007: 127-131).

- By the end of December 2006, the banking sector was gradually made accessible to foreign competition. Ditto for purchasing shares of Chinese banks. For example, the majority share hold of 20 percent in the Guangdong Development Bank was purchased by a Citigroup-led consortium. The complete liberalization of the banking sector will enable foreign banks to establish branch offices in China and also enable them to sell insurance products.

- State-owned investment banks are to change into a modern banking system with sufficient equity capital, strict internal controls and a high competitive edge. Banks will be allowed to establish investment funds as well. This will force valuation of investments in accordance with global value based management.
- The market for corporate bonds will be transferred to the more market based financial regulatory agency. Currently the National Development and Reform Commission sets annual quotas and authorizes the issue of bonds on a case by case basis.
- China herself is a player at the international stock markets and utilizes her steadily increasing reserves for strategic purchases. The China Development Bank for instance strengthened the Barclays offer in the take-over spectacle for the Dutch ABN Amro bank by purchasing Barclays shares worth 13.4 billion Euro. This resulted in a higher offer on the part of Barclays for ABN Amro. In addition, China recently provided her state-owned investment company with 200 billion dollar to invest in foreign industry and financial products. This led to China buying into the U.S. financial investor Blackstone.

China’s increasing economic clout is evident in the valuation of Chinese companies. Already out of eighteen of the most valuable companies, six are Chinese based on market capitalization. The expansion of the stock markets in China inevitably will further financial based value management with the primary assessment of cash flows and risk (market risk premium and systematic risk). Whether China can be categorized as more liberal or more group-oriented requires further investigation. China’s remaining elements of state regulation seem to suggest that China’s development represents a unique variety of the coordinated market economy model[3].

3. Impact of Value Management on Transfer Pricing

We already discussed that companies in countries all over the world deal with a set of institutional requirements over which they do not have complete control. Hence, in analysing comparative institutional advantage, public policy making must be addressed as well. A good example is transfer pricing. While specific legal regulations influence the economic arena in which stakeholders compete in the market, multinational companies apply

[3] The regulatory framework is officially proclaimed as: “socialist legal system”.

this legal framework in order to improve their performance and to increase their value. We begin with an explanation of the strategy of transfer pricing.

The goal of minimizing tax liabilities results in a globally active corporation that compares and takes advantage of the respective tax conditions and incentives in different countries. Subsequent to our analysis, we would like to reiterate that capital-market based pressure to increase corporate value brings about a rigorous emphasis on cost efficiency. The importance of site selection based on local tax conditions and the exploitation of international taxation differences is vital to value management. Corporations more than ever base their investment and site decisions on tax rates (Wei, Andreosso-O'Callaghan, von Wuntsch 2007: 164).

The strategy of the multinationals is to take advantage of their conglomerate structure. This set-up enables them to transfer profits to foreign subsidiaries with lower tax rates. This is made possible via the creation of transfer pricing for shipments and services within the conglomerate companies or corporate units. Corporate fixing of transfer pricing for miscellaneous sales offers tremendous potential for full exploitation.

Corporate strategy is clear. The value added chain is structured in such a way that companies settle in low taxation regions that earn high yields. Intra-company transfer-pricing accompanies and further augments this effect. Up-front services from a low tax region are typically priced high. The high tax country importer takes a loss and thus reduces taxable earnings and local tax liability. Proceeds accumulate in the low tax country, thus providing a great tax advantage for the conglomerate. Expert literature suggests that transfer pricing has developed into one of the most important tax strategies of transnational corporations (UNCTAD 1999: 2).

Individual countries on the other hand risk losing out on significant tax revenues. Their goal is to get their fair share of the international tax revenue. If one considers that intra-company trade between conglomerates constitutes almost sixty percent of all world trade, it becomes obvious that the business model of transfer pricing currently poses a significant challenge for countries with high taxation. In response, the internal revenue services of these countries retort with a correction of transfer prices. This again exposes the transnational corporations to additional risk. In addition to the prime correction of earnings by the national tax authorities, taxable earnings are essentially double taxed. Transferred earnings in low tax countries now stand in opposition to corrected earnings in the high tax countries, effectively resulting in double taxation, a definite drawback for the corporation. Corporations need to consider this added risk factor when devising transfer pricing (von Wuntsch, Bach, Trabold 2006: 248).

We’ll first describe how the creation of transfer pricing is intended to reduce the total tax burden on the conglomerate while increasing conglomerate value. Afterwards, we will focus on the responses of the individual tax authorities in different countries.

In order to exemplify the value effect of transfer pricing we will look at the example of German parent company A and Chinese subsidiary B. The Chinese company is wholly owned by the German parent. Starting in 2008, the German tax load for corporations totals 29.83 percent (15 percent corporation tax + 14 percent trade tax + 0.83 solidarity charge). For purposes of our example, we will use a simplified tax rate of 30 percent. Foreign investors enjoy a favourable effective average tax rate of thirteen percent in China. Chinese subsidiary B produces aluminium ingots that are sold to the parent company at transfer price x. We will analyze two scenarios with two different prices: (a) the market price (=200,000 Euro), (b) an exceeding transfer price (=250,000). The parent company A is able to sell the ingots on the market for 300,000 Euro. Subsidiary B produces the aluminium ingots at a cost of 100,000 Euro. The weighted average cost of capital (WACC) which will be used as discount factor when determining firm value is 10 percent. The simple model assumption is that both companies will face stable cost and income conditions in the future and that the increasing profit will result in a corresponding increase of free cash flow due to transfer pricing.

Scenario 1:

The Chinese subsidiary A sells aluminium ingots to the German parent B at a transfer price of 200,000 Euro. As far as this price represents the only cost element for the parent, the parent’s profit is 100,000 (=300,000 -200,000) Euro. Profit produced in China amounts to 100,000 (200,000-100,000) Euro as well. According to a simple assumption, profit after tax is identical with free cash flow (FCF), and can therefore be discounted with the cost of capital given (=10 percent)

Scenario 1: Market Price = 200,000 Euro

	Parent A Germany (in Euro)	Subsidiary B China (in Euro)	Group (in Euro)
Sales	300,000	200,000	
Expense	(200,000)	(100,000)	
Profit before tax	100,000	100,000	
German Tax (30 %)	(30,000)		
Chinese Tax for foreigners (13 %)		(13,000)	
Profit after tax	70,000	87,000	157,000
Cost of Capital (WACC): 10 %			
Value = FCF/WACC	700,000	870,000	1,570,000

Scenario 2:

The Chinese subsidiary A sells aluminium ingots to the German parent B at a transfer price of 250,000 Euro. The parent's profit is now 50,000 (= 300,000 – 250,000) Euro. Profit produced in China amounts to 150,000 (= 250,000-100,000) Euro. Again, we assume that profit after tax is identical with the Free Cash Flow (FCF), and can be discounted with the cost of capital directly (= 10 %).

Scenario 2: Transfer Price (250,000 Euro) exceeds Market Price

	Parent A Germany (in Euro)	Subsidiary B China (in Euro)	Group (in Euro)
Sales	300,000	250,000	
Expense	(250,000)	(100,000)	
Profit before tax	50,000	150,000	
German Tax (30 %)	(15,000)		
Chinese Tax for foreigners (13 %)		(19,500)	
Profit after tax	35,000	130,500	165,500
Cost of Capital (WACC): 10 %			
Value = FCF/WACC	350,000	1,305,000	1,655,000

This demonstrates that the strategy of transferring profits to a low tax country results in value appreciation. For the group as a whole, the higher transfer price results in value appreciation by 85,000 Euro, i.e. 5.4 percent.

The advantage is clear. There is a tremendous incentive to sell high priced goods and services to subsidiaries in low tax countries. This trend has been substantiated within the OECD countries. Moreover based on a study commissioned by UNCTAD, eighty-four percent of all developing nations believe that profit transfers are solely intended for the purpose of reducing taxation (UNCTAD 1999: 31).

4. Institutional Response in Europe and Asia

Transnational corporations will nevertheless have to limit their risk exposure to the counter measures implemented by national tax authorities, intent to safeguard national tax revenues. The correction of inappropriate transfer pricing based on national legal grounds is indeed possible and may result in international double taxation of transferred profits. Profits that are transferred to a low-tax country following primary correction via the internal revenue services in the high tax countries will also be exposed to upwardly corrected profits. Corporations cannot but consider the risk of double taxation in their tax planning strategies. If a corporation has any justified reservations, which it cannot refute, it must adjust its transfer price. This requires an immense amount of information on the part of the tax authority. Corporations are required to make available all information regarding determination of the appropriate transfer price to the tax authorities. However, the premise is that there is no system of correct transfer pricing. This is in part due to the fact that national tax authorities diverge in their interpretations thereof. Disputes involving mediation and arbitration can evolve over several years. Since exact price determination is impossible, experts agree that appropriate transfer pricing operates within a range. This effectively means that in spite of profit corrections by the tax authorities and double taxation, corporations retain sufficient opportunity for the exploitation of corporate tax strategies. Only the standardization of different tax systems and tax rates would eliminate transfer pricing intent on reducing corporate tax liabilities. Within the EU there have been proposals to establish measures for standardizing the assessment criteria and tax rates. Still, even here tax differences will likely not be eliminated in the near future. Transnational corporations will have to gauge their leeway when devising transfer pricing in order to avoid risk[4].

The uncertainty in structuring transfer pricing affects the upper and lower range margins. Differing interpretations by different national tax authorities may meet head-on. This impasse arises because only one of the respective

[4] This lends itself to a cost/use analysis at the corporate level to determine the benefits of avoiding a tax audit vs. the significant cost of generating price documentation with in the framework of advanced pricing agreements (APAs).

tax authorities determines the appropriateness of pricing. The lower range can give rise to disputes when dealing with shipments from high tax countries to low tax countries. The stance taking by the tax authorities of countries with high taxation is to prevent a scenario where earnings are underreported. That still leaves plenty of risk-free opportunity for companies to fully maximize.

Once a relatively stable range of appropriate transfer pricing has been established, we can determine the risk zone. Our case in point focuses on a high purchase price in a high tax country.

Risk affecting Transfer Pricing

Range of Risk affecting Transfer Pricing		
Inappropriately high purchase price	Range of appropriate transfer pricing	Inappropriately high sales price
Low profit in the high tax country	Potential for profit transfer ⇒	High profit in the low tax country
Profit increase via primary correction		
Risk zone Double taxation		

According to a study commissioned by Ernst & Young in 1999, 78 percent of surveyed multinational corporations were audited at their subsidiary level regarding transfer pricing. Based on the survey frequency of the countries involved, there were significant differences between these countries. 42 percent of all the corporations that had to adjust their earnings subsequently had to address the issue of double taxation (Ernst & Young 1996: 26). Based on the updated study of 2003 (Ernst & Young 2003: 23) this figure amounts to 40 percent.

We set out to demonstrate that transfer pricing is an important corporate tool in order to achieve value added results on a global scale. The strategic objectives of value management are thus in perfect agreement with this concept. Furthermore, we pointed out that beginning in the 1990s, the tax authorities of the individual countries have started to respond to the significant loss of tax revenues. So far this resulted in fairly broad support among countries for the adoption of OECD Transfer Pricing Guidelines (OECD 1995). This is especially true of the ‘dealing at arm’s length’ principle, which emphasizes external comparison. This principle states that prices set on transactions between related parties should be determined as though these parties were independent.

In order to facilitate external comparison for the correction of transfer pricing, the OECD suggests standardized and profit-oriented methods. The

Comparable Uncontrolled Price Method (CUP)[5], the Resale Price Method (RPM)[6] and the Cost Plus Method (Cost Plus)[7] are referred to as standard methods whereas the Transactional Net Margin Method (TNMM) and the Profit Split Method (PSM) constitute the profit-oriented methods. The limitations of the standardized methods have been much debated on the international level (UNCTAD 1999: 9). In essence, application of this model is limited to relatively straight-forward, standardized exchange relationships. With respect to the exchange of services however, things are getting increasingly more complex. First of all, the number of uncontrolled transaction decreases. Additionally, supply chains experience more and more subdivision. Thirdly, the importance of intangibles is witnessing strong growth, leading to expansion of special rights such as licensing rights and patents. Standardized methods are unable to effectively deal with these developments.

The OECD responded to the introduction of profit-oriented methods in the U.S. with its ‘Transfer Pricing Guidelines 1995’. Additionally it recommended the Profit Split Method (PSM) and the Transactional Net Margin Method (TNMM) to address exceptions as traditional transaction based methods don’t account for price fixing. The idea of PSM is to determine the overall profit from a *controlled* transaction and then split the profit between the two parties based on each party’s contribution. According to TNMM, the net profit margin that related enterprises could earn should be comparable with that of unrelated enterprises. The German tax authorities have been very critical of this. Except for the previously introduced profit-oriented methods (PSM and TNMM), the OECD rejects global profit methods. The Comparable Profit Method (CPM) and the Global Formulary Apportionment Method (GFAM) represent the global profit methods.

In the U.S. the Comparable Profit Method (CPM) is in effect without restrictions, notwithstanding the fact that the OECD rejected this method. The share resulting form the borderless business relationship stands in opposition to the fictitious comparable profit of total corporate profit, which is calculated based on return ratios of comparable companies. Thus the entire premise of the ‘at arm’s length principle’ is already violated. The Global Formulary Apportionment Method (GFAM) follows the principle of unitary taxation. Here the conglomerate is viewed as an entity, which is why the intra-corporate exchange of services is completely factored out. Total realized profits of the conglomerate are instead apportioned based on an

[5] Transfer Price for Controlled Transactions = Transfer Price for Comparable Uncontrolled Transactions

[6] Transfer Price = Selling Price less Gross Margin that would be charged by unrelated firms under the same circumstances.

[7] Transfer Price = Standard Cost of Production of the related seller plus Cost Mark Up that unrelated sellers would charge

abstract formula, and spread over the individual corporate sub entities. This too is in complete opposition to the ‘dealing at arm’s length principle’.

Transfer Pricing Methods

Globally applied Methods at the Parent Company Level (repeat entries)			
	Material Goods %	Services %	Licensing (Agreements) %
Comparison method	35	20	37 internal 15 external
Resale method	18	0	0
Cost method	0	16	0
Cost plus method	31	57	1
Profit split method	5	0	10
Profit based method	7	0	17
Others	8	7	23
Undetermined methods	1	1	1

(Ernst & Young 2003: 17)

The OECD Transfer Pricing Guidelines 1995 represent more a consensus of viewpoints and do not identify areas of contention or disagreement amongst the OECD member states. This has led to significant differences between countries with taxpayers left to divine which methods are acceptable. For example, Canada eschews statistical analysis to determine an arm’s length TNMM result whereas U.S. regulations mandate the use of the inter-quartile range when using inexact comparables (Ernst & Young 2006: i).

It is interesting to note that on the whole, countries follow the methods recommended by the OECD. Germany tends to be more in line with the CUP, Resale Price and Cost Plus methods but refers to TNMM and PSM when dealing with exceptions. Japan operates in a similar manner. These countries apply the ‘dealing at arm’s length principle’ more cautiously. By contrast, it is noticeable that China tends to follow the U.S. example more closely with regard to accepted methods and also applies the controversial Comparable Profit Method.

In view of the tightened requirements for the documentation of transfer pricing that are generally in effect, several Asian countries decided to abide within the framework of the Pacific Association of Tax Administrators (PATA). These include Australia, Japan, Canada and the U.S. Inline with the EU, PATA places limits on the duties of the tax payer. The taxpayer is required to produce an analysis of transactions between related companies and an analysis of comparable transactions between independent companies and calculate transfer pricing that is compatible with OECD guidelines. Presently, the PATA member states have ratified the most bilateral Advanced Pricing Agreements (APA). The PATA guidelines for conducting APAs are based on OECD guidelines ("Guidelines for Conducting Advance Pricing Arrangements under the Mutual Agreement Procedure-MAP APAs").

In 2004 China for the very first time issued regulations, which enables the taxpayer to augment their legal footing with regard to the audit of transfer pricing. These new regulations enable the utilization of APAs as a means to avoid conflict with the Chinese tax authorities. Still, it is not always possible to join the APAs anonymously in pre-negotiations.

5. Concluding Comments

The analyses of transfer pricing are currently dominated by the point of view of the industrialized nations. Empirical studies mainly focus on the U.S.A., Japan and the European Union. Only few studies examine transfer pricing policies for companies operating in developing countries[8]. Rather they suggest that due to the differences in business environment, nontax factors such as restrictions on profit repatriation and foreign exchange control are more important. This has been shown for China (Chan, Lo 2004: 93). Export-oriented foreign companies as compared to Chinese market-oriented enterprises have lower tariff costs and lower non-tax costs for shifting profit out of China due to the exemption of import tariff. As far as both Hong Kong and Taiwan have lower tax and nontax costs for shifting profit, there is an incentive to evade tax through transfer pricing. This kind of company is more likely to be audited by the Chinese tax authorities.

The UNCTAD survey on transfer pricing (UNCTAD 1999: 31) also revealed that developing countries felt that the foreign affiliates operating in their countries use income shifting to avoid tax liability. The reaction to transfer pricing appears to underline the diverging interests of the industrialized nations, the emerging markets and the developing countries.

The analysis of company strategies and institutional conditions in different countries presents a diverse picture. Although companies in the previously discussed countries experience strong pressure towards standardization or convergence, regional variation persists. Corporate boards almost universally embrace the idea of maximizing shareholder value. The

[8] According to the IMF (2003) China is in essence still a developing economy. Over the last two decades, China has emerged as the largest FDI recipient among the developing countries.

institutional foundations in Asia and Europe however vary between liberal market economies and coordinated market economies. Another dividing line centres on transfer pricing. Institutional responses in different countries are based on diverging interests of developing and industrialized nations. Thus the institutional responses of these countries interfere with the previously introduced models of the liberal market economy versus coordinated market economy. The developing and emerging nations of which China officially continues to be a part have their interests at stake and must protect them. In my opinion, future investigations ought to address this issue more thoroughly.

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