CORPORATE PRACTICE OF TRANSFER PRICING AND TAX EVASION: EMERGING PROBLEMS AND EXISTING SOLUTIONS

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ABSTRACT

Transfer prices play an important role in the billing of services to affiliated companies. By determining the level of these prices, profits can be shifted across the border and thus the total income taxes of the group can be reduced. The individual countries therefore endeavour to ensure that the transfer price for services rendered in their own country is set as high as possible. Here, at the very least, market prices, as negotiated between external companies, must be applied. This leads to the problem of determining transfer prices in line with market conditions. This paper examines possible solutions in the literature and how they are dealt with in practice. It also examines whether companies are motivated at all to influence their transfer prices. In addition to the perspective of companies, this paper also examines the views of governments on how to set transfer prices. A literature review is used to assess the state of research and to present the current transfer pricing practices of corporations. Furthermore, the problems arising with transfer pricing and the approaches found in the literature are presented. Finally, current gaps in research on the topic of transfer pricing are pointed out. This paper aims to reflect the current state of research on transfer pricing issues.

Keywords: Corporate Taxation, transfer pricing, CCCTB.

INTRODUCTION

Tax avoidance has become a real competition among companies. Therefore, attempts are being made to transfer profits to countries with lower taxes. The overarching problem is that cross-border companies are encouraged to reduce their consolidated profits and thus their tax burden by setting their transfer prices with affiliated companies (Kleinschnittger, 1993). However, this then leads to a tax reduction race between countries (Fremerey, 2017; Müller, 2004). The digital transformation raises additional questions, such as the question of new legal relationships between government and companies and taxation in a digital economy (Miethlich, Belotserkovich, Abasova, Zatsarinnaya & Yeselitsky, 2020).

Despite restrictions on the possibilities of manipulation by the tax authorities, there is sufficient scope for setting the transfer price accordingly high or low. This is because there are too many different approaches or methods to determine the transfer price for a product or service (Pfeiffer, Schiller & Wagner, 2011). In model analysis, the problem often arises that not all costs are considered in addition to tax expenses. In addition to taxes, transport costs, storage costs, customs duties and exchange rates must also be included in the analysis (Gao & Zhao, 2015). The Institute of Unitary Tax as an alternative to transfer prices is also cited as a possible solution, as it is supposed to be more objective and is therefore not as easily susceptible to manipulation as the transfer pricing approach (McAulay & Tomkins, 1992).

Despite years of discussion about the appropriateness of transfer prices and the tax authorities' requirements for solutions, the problem of manipulation has still not been eliminated. Therefore, alternatives are also being sought which are better and more objective than transfer pricing. This is where the tendency towards a so-called “unitary tax” approach becomes apparent, which in fact cannot be manipulated as easily as when transfer prices are set (McAulay & Tomkins, 1992).

Therefore, a literature review, the corporate practice of transfer pricing, the problems caused by transfer pricing as well as the known solution approaches are to be pointed out and evaluated.

METHODOLOGY

The research was conducted by searching the databases Google Scholar for published literature since 2010 in the subject area Common Consolidated Corporate Tax Base (CCCTB) with a focus on transfer pricing. For the in-depth analysis, articles published in peer-reviewed journals and conference proceedings were selected. Additionally, the reference lists of all previously selected articles were checked to find further studies. The literature was evaluated regarding emerging problems and existing solutions with regard to transfer pricing and tax evasion of companies.

LITERATURE REVIEW

The current transfer pricing practice of companies is that they seek to reduce their tax burden within the group. To this end, they are willing to manipulate their transfer prices. Transfer pricing policy is taken into account in decision-making models of groups. This is mainly limited to minimizing the tax burden and no other influencing factors (Hammami & Frein, 2014; Hirshleifer, 1956). It also provides a framework for optimal decision making in global supply chains with uncertain and price-dependent demand (Ernst & Young 2010-2013; Wang, Gao & Mukhopadhyay, 2013). Where there is low cost uncertainty, centralised standard methodologies predominate in transfer pricing. In contrast, the actual cost method (mark-up method) prevails if the cost uncertainty is high and if the buyers have sufficient information about the supplier's costs. In contrast, the reported standard cost methods predominate when the cost uncertainty is high and when the buyers have insufficient information about the costs (Pfeiffer, Schiller & Wagner, 2011). The determination of transfer prices can have four different motives, which are divided into functional, economic, organizational and strategic purposes (McAulay, C. R. Tomkins, 1992). On the other hand, one even speaks of 15 major motives for manipulating transfer prices. However, the main motive is considered to be maximising economic profit and increasing competitiveness (Lin & Chang, 2010). The literature calls for companies to adopt a new transfer pricing strategy that not only minimises tax expense. The goal must be to maximize the group profit taking into account all expenses (Gao & Zhao, 2015). In general, transfer pricing serves the purpose of tax reduction. Inevitably, this also leads to an international reduction in tax rates (Müller, 2004; Schweizer, 2012; Sikka & Willmott, 2010). Transfer pricing methods do indeed avoid taxes, but according to a survey, these are concentrated in 450 large companies and 10 tax havens. The lower the tax rate, the greater the deviation from the market price. In contrast, market prices are applied by companies when the expected tax advantage is very small. However, the greater the price difference, the greater the volume of sales (Bernard, Jensen & Schott, 2006; Davies, Martin, Parenti & Toubal, 2018). There are two ways to avoid taxes across the border: activities and investments are located in low-tax countries (Foreign Direct Investment). The second alternative concerns tax planning techniques via transfer pricing and financing. In order to avoid these harmful arrangements, governments seek tax agreements and international cooperation (Genschel & Schwarz, 2011). So far, there is no model proposal to prevent the disadvantages of transfer pricing or its manipulation. There is still a need for research, despite the many different ways in which this problem has been dealt with in the literature (Padhi, 2019). The BEPS and CCCTB proposals are suitable instruments to eliminate the negative consequences in existing international tax law. However, concerns have been expressed that this is a 100% solution (Fremerey, 2017). The "Formula Apportionment" is intended to provide an alternative to transfer pricing. However, this rather objective method has its own problems. The EU Commission intends to introduce the Formula Apportionment as a uniform basis of assessment for corporation tax with formula-based allocation of consolidated profits (CCCTB) (Martini, Niemann & Simons, 2012). In corporate practice, there are many different approaches to transfer pricing. Companies use transfer pricing to maximise their consolidated profits. On the other hand, national governments are trying to take action to contain the problems that arise. The EU Commission, too, has been trying for many years to find a solution to the problem by adopting its own concept, namely the introduction of a CCCTB in all member states.

In order to prevent the transfer of profits to low-taxed countries by group companies, recognised transfer prices are used, which should correspond to the arm's length price (OECD, 2010). However, the use of transfer prices by internationally affiliated companies still causes various problems both on the part of the company and in the countries concerned. Ultimately, the analysis of the effects that transfer prices can have is itself a problem. In order to maximise their profits, they must reduce costs, including taxes. This is why the tax avoidance strategy is one of the important objectives of international companies (Ernst & Young, 2007; Fremerey, 2017). Taxes can be reduced by shifting profits to low-tax countries. This can be done by setting transfer prices. This poses the problem of achieving optimal transfer pricing policies for international companies (McAulay & Tomkins, 1992; Schweizer, 2012). The relocation of investments abroad creates not only tax effects but also other effects such as wage levels, quality of work, to name but a few. It is therefore not easy for companies to determine what goals they should pursue with transfer prices. The main concern of companies is how to return profits back to their home country in order to achieve greater economic gains (Lin & Chang, 2010). Since the decision-making problem is very complex, restrictions and simplifications must be made (Hammami & Frein, 2014). As a result, the optimal business objective cannot always be achieved. The traditional buy-back contract proves to be unsuitable for coordinating global supply chains. The existence of transfer pricing is changing the structure and policy of optimal decision-making in global supply chains (Wang, Gao & Mukhopadhyay, 2013). One problem for individual economies is the erosion of the tax base, as states engage in a potential tax reduction race to attract foreign investment and jobs. Every country is therefore trying to attract foreign companies with attractive low tax burdens (Fremerey, 2017; Müller, 2004; Schweizer, 2012). On the other hand, national governments have to contend with the fact that their tax revenues can easily be manipulated by setting the transfer prices of international companies (McAulay & Tomkins, 1992). Companies set transfer prices in such a way as to maximise their profits (Padhi, 2019). The tax burden of a corporation is reduced by shifting its profits to low-taxed countries. Taxes are reduced at home by domestic companies relocating their investments to countries with low tax levels (Martini, Niemann & Simons, 2012). Tax losses and unemployment are the consequences. This is where the real difficulty lies, as national governments find it difficult to curb tax avoidance strategies (Sikka & Willmott, 2010). There are far too many ways to reduce the tax burden in international companies. The individual state governments affected by this do not always succeed in taking action or even in preventing it (Genschel & Schwarz, 2011). There are different approaches or methods for determining transfer prices. For example, the standard method can be the price comparison method, the resale method and the cost-plus method (OECD, 2010). In addition, there is also the transaction-related net margin method and the profit distribution method (OECD, 2010). The cost-based transfer pricing methods can be divided into centralized standard cost, actual cost and reported standard cost methods, depending on the level of cost uncertainty. There are thus different variants of cost-based transfer pricing methods (Baldenius, 2000; Pfeiffer, Schiller & Wagner, 2011). These variants leave much room for manipulation in the approach to transfer pricing. This leads to the problem of determining the cause and amount of damage caused by such manipulations. How high is the fair market price to be applied? To limit the problem, most studies on transfer pricing do not consider any costs other than taxes (Gao & Zhao, 2015; Kassicieh, 1981). In fact, other influences such as wage levels, quality of work, political infrastructure and transport costs would have to be taken into account. There is also too little research data on prices of international companies and the corresponding market prices (arm's length prices) (Davies, Martin, Parenti & Toubal, 2018). Therefore, it remains difficult to determine in individual cases whether a tax shortfall has occurred at all and how high it is. The problems that arise when transfer prices are set by internationally associated companies are of a diverse nature and do not focus solely on the tax effect. It is difficult to determine whether a tax deferral has taken place at all and what its extent is. It is not easy for companies to achieve an optimal transfer pricing policy. It is very difficult for individual countries to combat and contain tax evasion. The problems do not seem to be solved even by transfer pricing policies accepted by national economies.

To avoid the problems caused by transfer pricing, there are various approaches in the literature to solving them. One approach aims at avoiding tax competition between countries through tax cooperation (Genschel & Schwarz, 2011). A literature review is well suited to develop models to prevent manipulation in the determination of transfer prices (Padhi, 2019). In this context, it should be examined why one or the other approach is chosen to avoid the problems in practice and why (Pfeiffer, Schiller & Wagner, 2011). Decision models in the literature take transfer pricing policy into account, but they are limited to the minimization of tax expense (Hammami & Frein, 2014). Transfer pricing is not only an accounting technique, but also a method of resource allocation and tax avoidance. They also affect the distribution of income, assets, risks and quality of life. Governments therefore demand more transparency on the transfer pricing policies of companies in all countries concerned in order to solve the transfer pricing problem in this way (Sikka & Willmott, 2010). The data used in these models represent prices only from companies that supply goods (Davies, Martin, Parenti & Toubal, 2018). In order to maximize consolidated profit, the determination of transfer prices within a group must also be examined. This involves taking into account transport costs, storage costs, taxes, customs duties and exchange rates (Gao & Zhao, 2015). Another solution offers a modified distribution agreement on revenue sharing to coordinate global supply chains (Wang, Gao & Mukhopadhyay, 2013). As a solution to the transfer pricing problem, the US has introduced a formulaic allocation method (Sikka & Willmott, 2010). This 'unitary tax' as an alternative to transfer pricing is more objective and cannot be manipulated as easily as the transfer pricing approach (McAulay & Tomkins, 1992). In order to avoid manipulation by transfer pricing policies in cross-border companies, the literature suggests the introduction of a formulaic allocation of group profits, as in the US (Martini, Niemann & Simons, 2012; OECD, 2015). The EU Commission proposes the introduction of a uniform assessment basis for corporation tax with a formulaic allocation of consolidated profits (CCCTB). In contrast, the OECD's BEPS proposal aims at concrete recommendations against harmful tax competition between states and aggressive tax planning by international groups of companies (Fremerey, 2017). Another proposed solution aims at establishing an internal transfer pricing committee (Lin & Chang, 2010). In summary, many and various approaches to contain the problem of transfer pricing manipulation have been developed in the literature.

CONCLUSIONS

The analysis of this paper leads to the conclusion that, despite years of dealing with the issue of transfer pricing, there is still sufficient need to better manage the negative effects. An acceptable solution to the problem still does not exist at present. The proposals in the literature aim at the inclusion of all expenses so that income taxes are not only considered one-sidedly. Recommendations also go further and, in decision-making strategies, also take into account the quality of work, wage levels, transport costs and political infrastructure in the state in which profits are to be shifted because of lower taxes.

From the point of view of a corporate group and a state government, the different views on transfer pricing are presented in the literature. There is still a need to fill the existing research gaps and to address the problems of transfer pricing. Here, it seems important to me to focus on alternative solutions to transfer pricing. In this way, the existing problem of determining transfer prices, which is a market-driven and arm's length price, could be avoided. However, these alternative approaches themselves should again be critically examined to see whether they do not shift the problem to other instruments.

The forthcoming introduction of a uniform tax base by the Commission of the European Union with the formulaic allocation of the total profit to the individual states concerned (CCCTB) appears to be of particular relevance in this discussion of the various approaches to a solution. This should be a good solution to prevent tax manipulation by companies. The reform proposal is important for the whole European Union and would be a novelty. For this very reason, there are good opportunities here to examine the advantages and disadvantages of this group taxation from all points of view. Interesting contributions can be expected in the critical literature.

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