Transfer Pricing: Growth of the Concept and Fiscal Regulations in Europe

Renata Fulop
Babeș-Bolyai University, Romania

Abstract

Organisations these days are growing rapidly, and both operational activities and business networks tend to use business unit strategies to overcome operational complexity. This constantly growing environment can significantly impact multinational transfer pricing practices. The research aims to look at the historical evolution and understand how the transfer pricing concept was changed over time and how the accounting legislation influenced the concept. One tool to achieve this goal is historiography and documentary research, which we applied to make it an accessible topic for further applications, studies, and analysis.

Keywords: transfer price, history, evolution, legislation, arm`s length principle
JEL classification: M4, H25, F23, H87

Paper type: Research article
Received: 24 January 2023
Accepted: 21 March 2023

DOI: 10.54820/entrenova-2023-0031

Introduction

Transfer prices (TP) are the prices at which transactions between companies within the same group take place, which must be equivalent to the prices at which a similar transaction would have been concluded between independent parties under comparable economic conditions (Cools, 2014).

In business internationalisation and globalisation, most transactions in world trade occur between companies of the same group, so TP has become the top priority on the fiscal agenda. A multidisciplinary approach is required to understand the issue of TP and effectively address the problems on this subject.

According to Barnes & Messina (2020), at the beginning of the concept study, TP was known in management accounting as a pricing policy applied to the delivery of goods or services between divisions within a company to measure the performance of each of these divisions. Along with the times, multinational companies (MNC), which usually implement decentralisation of operations by dividing their companies into responsibility divisions, both cost and income divisions, have taken advantage of TP as a means of avoiding taxes by minimising the tax liability that the company must endure.

According to Susanti and Firmansyah (2018), one of the management motivations for TP is the interest in bonuses. Management seeks to increase profits as a basis for bonuses through TP transactions. As the decision can affect the company's profit and loss, division managers are usually involved in TP decisions, so they have control over overall profitability. The basic purpose of TP is to encourage managers so that their actions or decisions always prioritise the interests of the company as a whole. However, the purpose of TP is increasingly divided along with the transactions made by MNCs that transfer goods or services by crossing the border of a country.

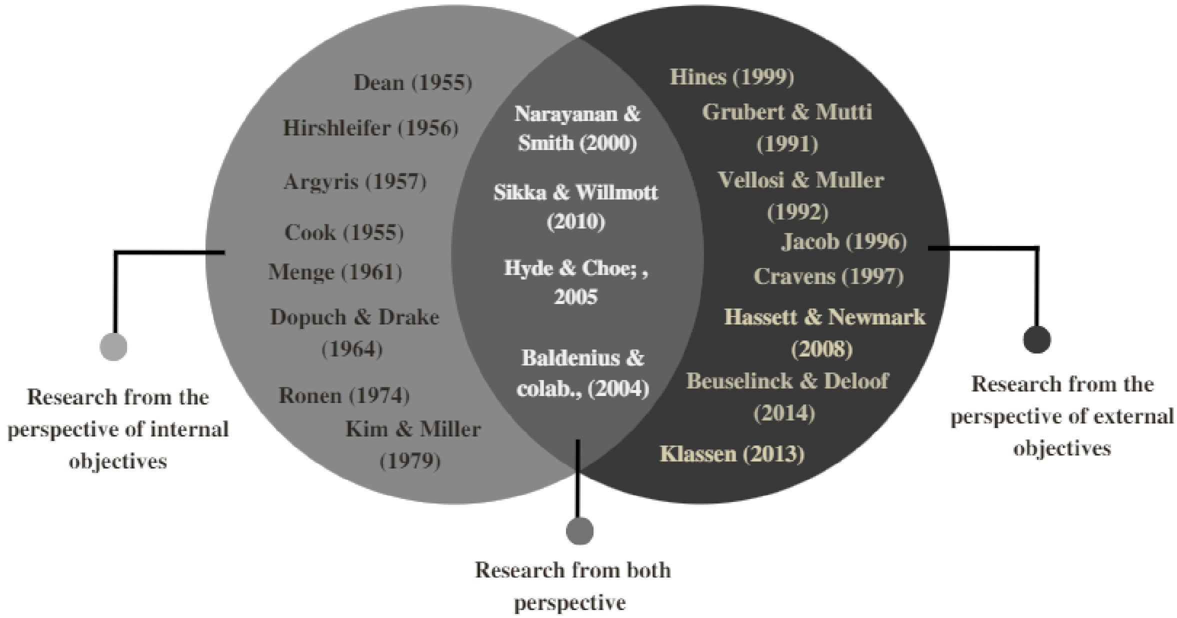
Most of the studies investigate whether companies in low-tax jurisdictions are more profitable than companies in high-tax jurisdictions or whether economic activity varies by location. Clausing (2003), through his research, was able to demonstrate that there is a significant relationship between tax rates in the United States (US) and the application of TP. Similar results were obtained by Lo et al. (2010), who clarified that taxes could influence TP decisions for companies registered in China. Weichenrieder (2009), through his empirical results, shows that more MNCs shifted their profits to their German divisions when Germany had lower tax rates.

Therefore, TP is currently one of the most widely debated subjects among professionals, researchers, and tax authorities. It can be grouped into two major areas: fiscal/tax and corporate management.

Literature review of transfer pricing. A two-way perspective

According to Barnes & Messina (2020), in the beginning, TP was known in management accounting as a pricing policy that applied to the delivery of goods or services between divisions within a company to measure the performance of each of these divisions. Over time, MNCs that typically implement decentralisation of operations by dividing companies into divisions of responsibility, both cost and revenue divisions, have taken advantage of TP as a means of tax avoidance by minimising the tax liability the company has to bear. Regarding the specialised literature in the following section, we propose to analyse TP research from two different perspectives: the perspective of corporate management (internal objectives) and the fiscal perspective (external objectives).

Figure 1
Researchers' perspective approaches



Source: Author's illustration

The corporate management perspective approaches TP from a technical point of view, using TP for internal purposes such as allocating resources within the group. TP is used both to coordinate MNCs to achieve set objectives and to evaluate the individual performance of managers or divisions. Creating a TP system can help MNCs achieve goals such as minimising taxes and maximising profit.

The fiscal perspective tries to outline regulations that ensure the TP does not deviate from market values, thus avoiding distorting the taxable base in the different jurisdictions in which the MNC operates.

In Figure 1, we can note that the first analyses of TP researchers were carried out in the period 1950-1960. Authors such as Dean (1955), Hirshleifer (1956), and Argyris (1957) analyse the concept of TP mainly for corporate management purposes. The first author to mention TP as a problem was Cook (1955), who considered that a decentralised company expects increased profitability by giving direct incentives for profit and valuations to more people in management. For this to be successful, the company must ensure that a profit-making division is not driven to increase its profits by reducing the profit of the company.

Menge (1961) argued that the process of establishing TP rules was long and never completely successful because the procedures for determining the prices of products and services transferred between company divisions were to be determined by negotiation between the buying and selling divisions. Also, prices must be close to competitive levels so that divisional profits can be a measure of performance. The author suggests a logical alternative to the TP system. One proposal would be to give divisions more freedom to determine their selling and buying policies.

Dopuch and Drake (1964) suggest that confidence in a simple measure of performance, such as a profit and loss index, is not fully warranted in TP. If there are actual prices for units of output at the stages where resource allocation decisions are appropriate, then these prices will serve both the decision-making and evaluation functions. Ronen (1974) suggested a TP-setting plan that achieved fair reporting from decentralised divisions that made independent production decisions, resulting in overall profit maximisation.

Kim and Miller (1979) conducted empirical research to understand the factors driving TP decisions in early US MNCs. Their findings noted that restrictions imposed by the parent company on the relocation of profits are one of the main factors influencing TP's decision.

Over the years, researchers' focus has changed, and TP analysis has shifted towards the fiscal perspective. Since the 1991s, most studies have examined whether companies in relatively low-tax jurisdictions are more profitable than companies in high-tax jurisdictions or whether economic activity varies by location.

Hines (1999) surveys this literature and finds a negative correlation between tax rates and firm profitability.

Grubert Mutti (1991) investigated income change and planning opportunities used by multinationals and addressed several international taxation issues.

The approach of Velloso & Muller (1992) is a classical approach, which assumes that the TP manipulates the expenses and revenues of the affiliated entities to obtain tax benefits.

Cravens (1997) attempted to deepen understanding of the influencing factors in TP policymaking using both qualitative and quantitative measures. The author tested several main hypotheses: performance, evaluation, motivation, and goal congruence. These hypotheses were tested using the objective rather than the pricing method because firms pursue different objectives. Based on his findings, Cravens (1997) pointed out that TPs are seen as an effective tool in managing the tax burden.

Klassen's (2013) work was based on a survey of 219 MNCs. The paper shows that MNCs do not always mean evading taxes by using the TP mechanism; rather, the strategy and policy have legitimately contributed to tax reduction.

Similarly, Hassett & Newmark's (2008) study referred to it as "the MNC practice of arranging sales between related parties so that most of the profit is made in a low-tax country. Again, two studies, one by Jacob (1996) and another by Beuselinck and Deloof (2014), further strengthened the findings.

Sikka & Willmott (2010) highlighted evidence showing that TP is not only an accounting technique but also a method of resource allocation and tax avoidance that affects income distribution and quality of life.

We can say that most of the TP researchers presented above can be classified into three groups and periods. The period 1950-1979 looks at TP mainly for corporate management purposes and is not concerned with tax issues related to TP. The following period began to analyse the impact of TP on tax rates. However, there are also many tax accounting studies (Narayanan & Smith, 2000; Baldenius & al., 2004; Hyde & Choe, 2005) that seek to determine the TP that meets both managerial and fiscal objectives at the same time.

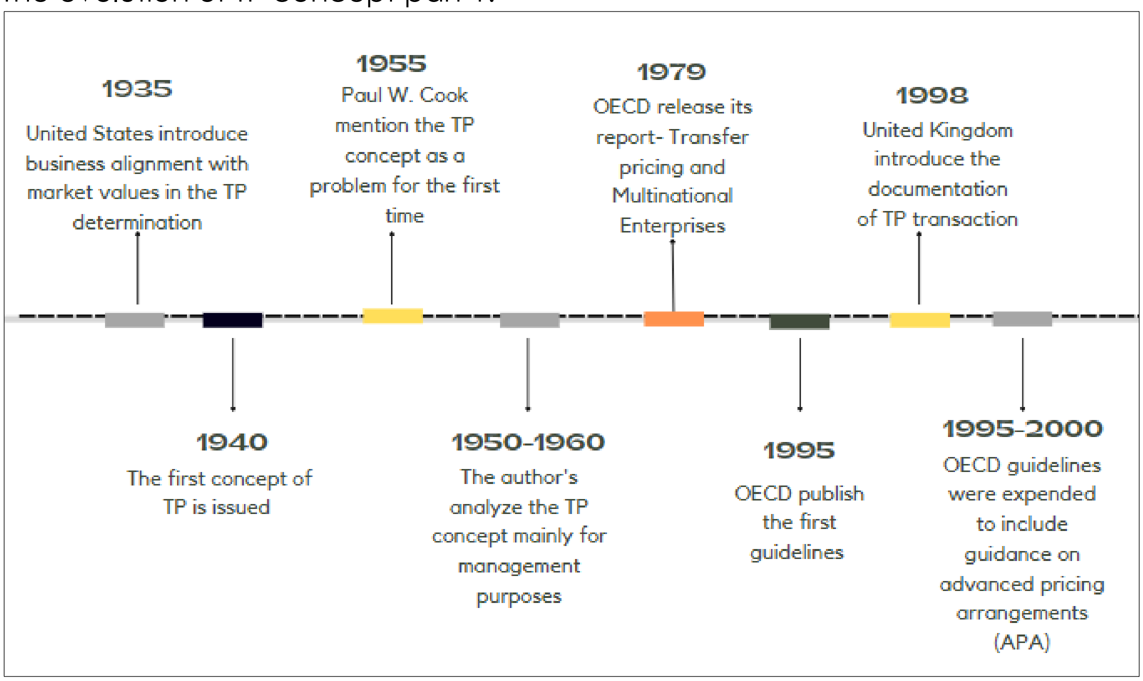
History and the evolution of the transfer pricing concept

According to Mirjam (2015), the history of TP began after the First World War, when the US paid special attention to how the profits were allocated between companies, and the consequence of this pressure was that the US was the first country which implemented TP legislation and introduce the "arm's length principle" (ALP). According to ALP, MNCs should have wondered what price would have been set by an independent company operating in a competitive market to provide comparable services. After the Second World War, the US, starting from the ALP, elaborated and adopted the first TP regulations (Mirjam, 2015). Later, other countries, such as Australia, Germany, Indonesia, Italy, and Japan, demonstrated interest in TP and adopted legislation in this sense (Lohse et al., 2012). Moreover, for the development of some regulations at a global level in the sphere of prices of transfer, in 1979, the Organization for Cooperation and Economic Development (OECD) published a report regarding the allocation of profit and expenses between affiliated companies.

This section aims to trace the history of the TP concept and its evolution. The important thing to remember is that history writing does not only explain what happened but also why it happened the way it did.

In Figure 2 and Figure 4, we extract those key events that contributed to the TP concept evolution.

Figure 2
The evolution of TP concept part 1.



Source: Author's illustration

It was in the 1930s that the issue of TP entered the fiscal debate, and some MNCs in the U.S. began using it for tax avoidance purposes. MNCs were accused of performing tax avoidance on an industrial scale by shifting profits to lower-tax jurisdictions through TP techniques. The main advantage of this practice is that taxable profits are not omitted but just allocated to a specific place/country where they are subject to a low tax rate. Later, empirical studies provide strong evidence of this behaviour of MNCs (Swenson, 2001; Bartelsman & Beetsma, 2003; Clausing, 2003; Cristea & Nguyen, 2016; Davies et al., 2018).

To reduce these MNC activities, in 1935, the U.S. introduced business alignment with market values in the determination of TP (Pavone, 2020).

Padhi (2019) claims that the first concept of TP was revealed during the 1940s, and the first models were developed during the 1970s and 1980s. The arm's length principle (ALP), which was well known as a rule against manipulating TP, represents the key pillar of TP rules and the standard that has been used in the international tax field since 1933.

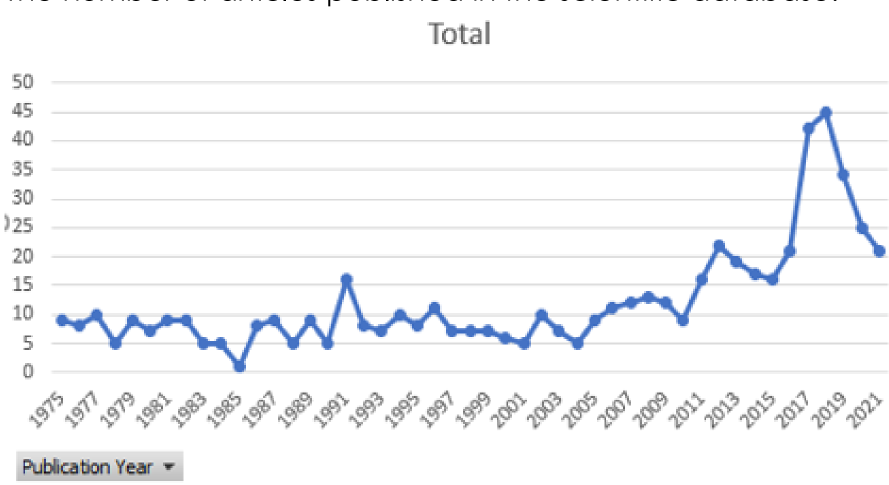
The first scientific and professional articles focused on TP began to appear at the beginning of the 1950s (Dean, 1955; Heflebower, 1960), and until about the 1960s, researchers were not concerned with the fiscal problems relating to TP but dealt with aspects of a purely managerial nature.

Hirshleifer (1956) provides classic examples of situations in which rational divisional managers' decisions reduce the company's profits.

The TP rules have been developed mainly by members of the OECD because of their historical and economic background. Regarding the technical framework of the history of TP, in 1973, there was the first meeting of the OECD, which is an intergovernmental organization with 38 member countries, founded in 1961 to stimulate economic progress and world trade (OECD, 2017). Two years later, in 1975 TP and the setting of TP in harmony with the ALP have been considered one of the most discussed and problematic tax issues.

The complexity and importance of this topic can also be demonstrated in Figure 3, which shows the growing number of articles published in the recognized worldwide Web of Science database.

Figure 3
The number of articles published in the scientific database.



Source: Author's illustration

In 1979, the first guidelines on TP were drafted, which would be useful in practice to clarify the various problems that emerged in the framework of legal and economic transactions. In 1984, the first report on TP was drafted, targeting the area of production and services to provide an overview of the applicability of this concept.

The Taskforce for TP within the OECD organised a working meeting in 1993 to debate the main issues faced by MNCs. These meetings explored establishing the first TP guidelines in 1995, namely the 'Transfer Pricing Guidelines for Multinational Enterprises and

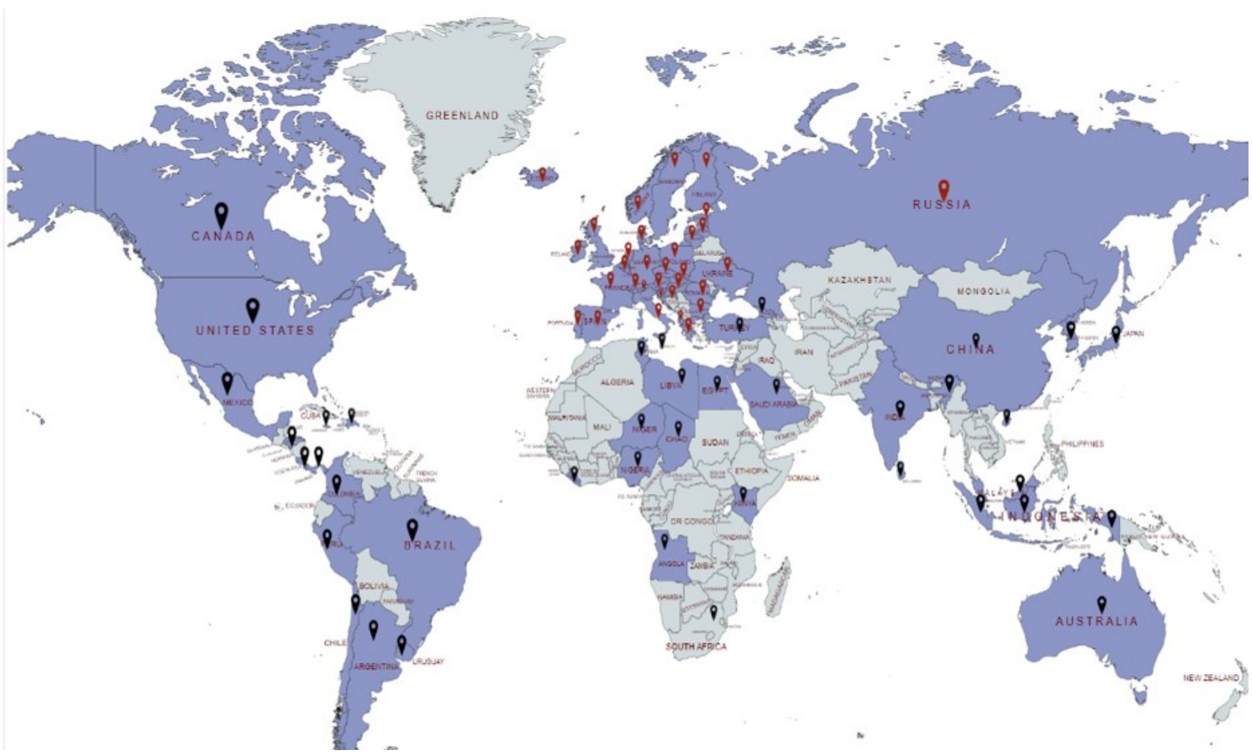
Tax Administrations, ' which were considerably improved in 2010 and 2017 and subsequently in 2022, when the OECD published the newest transfer pricing guidelines.

Abdel-Khalik and Lusk (1974) draw attention to a range of dysfunctional consequences of the TP mechanism, including manager behaviour in which they manipulate the results to their advantage. Eccles (1985) also suggested that some managers use conflict as an important part of their management style. However, Lawrence and Lorsch (1967) suggested that negotiation can be an important way of conflict resolution.

Between 1995 and 2010, the guidelines were expanded to include guidance on advanced pricing arrangements. An advanced pricing arrangement is a formal arrangement between a tax authority and a taxpayer involved in cross-border related party transactions, where the objective is to determine an appropriate TP methodology for related party transactions according to the country's TP regulations (Eden & Byrnes, 2018).

Historically, the late 1990s and early 2000s can be seen as the first wave of TP activity as many countries introduced specific TP rules and documentation requirements, as can be seen in Figure 4. The information was extracted from both the tax code of each country and the official website of the OECD (2022), as well as from professional PT guides published by the Big 4 companies. Where we encountered language barriers, we relied on the official website of the OECD (2022), where the profile and legislation of each country are elaborated in English.

Figure 4
TP documentation requirements

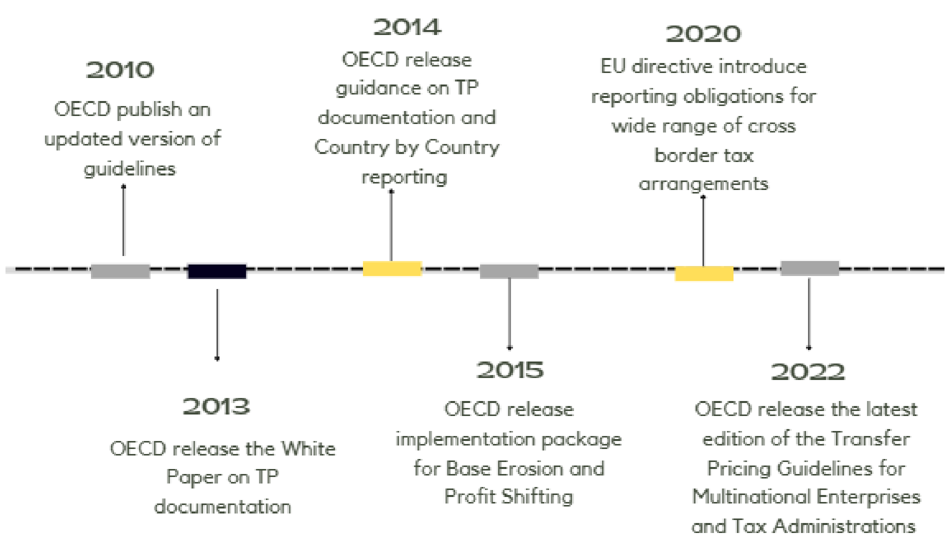


Source: Author's illustration

Since the 1990s, the US has undertaken TP reform and has continued to update and expand the legislation, influencing other countries that subsequently increase the rigour of their own rules by introducing TP documentation into law.

Taking the US legislation as a starting point and developing TP regulations globally, the OECD has published a report on TP that contains recommendations on applying the ALP to determine TP practised in related party transactions. The next period, 2010-2022, goes through the second wave of TP activity, which is the application of the OECD Guidelines, as Figure 5 also illustrates.

Figure 5
The evolution of TP concept part 2.



Source: Author's illustration

In this sense, future research directions could be represented by comparing TP with European countries. The work could represent a starting point for all future research directions mentioned above.

Conclusion

Our research indicates that transfer pricing and its intersection with taxation and accounting have increased the interest of tax authorities, practitioners, and researchers, especially in recent years, given the strength of multinational company growth.

This paper addresses the question of how the concept of transfer pricing has developed over time and the key elements that had a major impact on its delimitation. To answer this question, we investigated the issue from a historical point of view to identify the first practitioners of transfer pricing and how the legislation impacted the evolution of transfer pricing.

Firstly, at the international level, we can say that its history began after the First World War when the United States began to pay attention to and introduce legislation in this regard. However, as Dean (1955) and Heflebower (1960) stated, the first practitioners were not concerned about the fiscal problems relating to transfer prices but analysed the concept purely for managerial reasons and identified that the concept was known in management accounting as a pricing policy that was applied to the delivery of goods or services between divisions/departments within a company to measure the performance of each of these divisions/departments.

During this time, multinational companies implemented decentralization of operations by dividing their companies into responsibility centers, both cost centers and income centers. They have also taken advantage of transfer pricing as a means of avoiding taxes by minimizing the tax liability, so starting from the 1970s, the setting of transfer pricing in harmony with the ALP has been considered one of the most discussed and problematic tax issues.

Secondly, at the national level, the first transfer pricing concepts were introduced into Romania's tax legislation almost 30 years ago but represent a relatively new concept in Romanian legislation. ALP was introduced in the fiscal code in 2004, and within it systematically presented the definition of affiliates, the principle of market value, and the methods of determination. In other words, in these transactions, the tax authorities may adjust the amount of the income or expenses as necessary to reflect the market price of the goods or services provided.

To keep up with the global reforms proposed by the EU and the OECD in the field of transfer pricing, companies need to find new solutions to cope with changes through documentation. As the number, size, and purpose of cross-border transactions increase, the effects of transfer pricing are thus increasingly important both for the profits of multinational companies and for the tax base of each country.

Even if many new transfer pricing rules were introduced from 1990 to 2022 and extensive documentary analysis of official documents and statements was undertaken, including the OECD Guidelines, OECD statistics, and national legislation, beyond the formally documented rules, the OECD Guidelines remain the "body of common understanding".

In the next period, many theoretical studies on transfer pricing responses to income tax differential studies on how multinational companies determine their TP will be conducted. The literature review on any topic tends to be complex due to the volume of published papers and the dynamism that this topic imprints over time.

References

1. Cools, M. (2014). Transfer Pricing: Insights from the Empirical Accounting Literature. Management Control and Uncertainty. Palgrave Macmillan, 14-29.
2. Barnes, K., & Messina, W. (2020). Transfer Pricing: Purpose of Determination and Factors Affecting Transfer Pricing Determination. Journal Dimensie Management and Public Sector, 1(1), 27-34
3. Susanti, A., & Firmansyah, A. (2018). Determinants of transfer pricing decisions in Indonesian manufacturing companies. Jurnal Akuntansi dan Auditing Indonesia, 22(2), 81-93.
4. Clausing, K., 2003. Tax-motivated transfer pricing and US intrafirm trade prices. Journal of Public Economics, 87(9-10), 2207-2223
5. Lo, M., Ramayah, T., Min, H. W., & Songan, P. (2010). The relationship between leadership styles and organizational commitment in Malaysia: Role of leader-member exchange. Asia Pacific Business Review. 16(1-2), 79-103.
6. Weichenrieder, A. J. (2009). Profit shifting in the EU: evidence from Germany. International Tax and Public Finance, 16, 281-297.
7. Dean, J. (1955). Decentralization and intracompany pricing. Harvard business review, 33(4), 65-74.
8. Hirshleifer, J. (1956). On the Economics of Transfer Pricing. The Journal of Business, 29, 172.
9. Cook, P. (1955). Decentralization and Transfer Pricing Problem. Journal of Business, 28, 87-94.
10. Menge, J. A. (1961). The Backward Art of Interdivisional Transfer Pricing. The Journal of Industrial Economics, 7(9), 215-232.
11. Dopuch, N., & Drake, D.F. (1964). Accounting Implications Of A Mathematical-Programming Approach To The Transfer Price Problem. Journal of Accounting Research, 2(1), 10-24.
12. Ronen, J. (1974). Social costs and benefits and the transfer pricing problem. Journal of Public Economics, 3(1), 71-82.
13. Kim, S. H., & Miller, S. W. (1979). Constituents of the International Transfer Pricing Decisions. Columbia Journal of World Business, 14, 69-77.
14. Hines, J. R. Jr. (1999). Lessons from Behavioral Responses to International Taxation. National Tax Journal, 52(2), 305-322.
15. Velloso, F. C., & Muller Brigagao, G. A. (1992). Volume LXXVII Cahiers de Droit Fiscal International, 313, International Fiscal Association
16. Cravens, K.S., (1997). Examining the Role of Transfer Pricing as a Strategy for Multinational Firms. International Business Review, 6(2), 127-145.
17. lassen, J. K., Lisowsky, P., & Mescall, D. (2016). Transfer Pricing: Strategies, Practices, and Tax Minimization. Contemporary Accounting Research, 455-493. doi:10.1111/1911-3846.12239
18. Sikka, P. and Willmott, H., 2010. The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness. Critical Perspectives on Accounting, 21(4), 342-356.
19. Narayanan, V.G., & Smith, M. (2000). Impact of competition and taxes on responsibility center organization and transfer prices, Contemporary Accounting Research, 17(3), 497-529.
20. Baldenius,T., Melumad, N.D., & Reichelstein, S. (2004). Integrating managerial and tax objectives in transfer pricing. Accounting Review, 79(3), 591–645.
21. Hyde, C.E., & Choe, C. (2005). Keeping two sets of books: the relationship between tax and incentive transfer prices, Journal of Economics and Management Strategy, 14, 165–186
22. Mirjam, K., (2015). Transfer Pricing in a BEPS Era: Rethinking the Arm' s Length Principle – Part I. International Transfer Pricing Journal, 3, 141-144.
23. Swenson, D. L., (2001). Tax reforms and evidence of transfer pricing. National Tax Journal, 54(1), 7-25.

24. Bartelsman, E. J., & Beetsma, R. M. (2003). Why pay more? Corporate tax avoidance through transfer pricing in OECD countries. Journal of Public Economics, 87(9-10), 2225-2252.
25. Cristea, A. D., & Nguyen, D. X. (2016). Transfer pricing by multinational firms: New evidence from foreign firm ownerships. American Economic Journal: Economic Policy, 8(3), 170-202.
26. Davies, R. B., Martin, J., Parenti, M., & Toubal, F. (2018). Knocking on tax haven's door: Multinational firms and transfer pricing. Review of Economics and Statistics, 100(1), 120-134.
27. Pavone, P. (2020). Transfer pricing: Business or tax process? Difficult equilibrium between two dimensions. Revista Espacios, 41(5), 21.
28. Padhi, K. (2019). Transfer pricing a review of literature. International Journal of Advanced Research in Management, 10(1), 7.
29. Heflebower, R.B. (1960). Observations on Decentralization in Large Enterprises. Journal of Industrial Economics, 9, 7-22.
30. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017. [online] Available at: https://read.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2017_tpg-2017-en#page1 [Accessed 23 November 2021].
31. Abdel-Khalik, R. A., & Lusk, E. J. (1975). Transfer Pricing-A Synthesis: A Reply. The Accounting Review, 50(2), 355-358.
32. Eden, L., & Byrnes, W. (2018). Transfer Pricing and State Aid: The Unintended Consequences of Advance Pricing Agreements. Transnational Corporations, 25(2), 9-36.
33. Grubert, H., & Mutti, J. (1991). Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making. The Review of Economics and Statistics, 73(2), 285-93.

About the author

Renata Fulop works as an Assistant professor at Babeș-Bolyai University. She graduated from Babeș-Bolyai University, where she got her master's degree, and she is a PhD student at the Faculty of Economics and Business Administration, Romania, Cluj Napoca. Her research interests are transfer pricing, financial reporting, transfer pricing legislation and management accounting. The author can be contacted at **renata.fulop@econ.ubbcluj.ro**