The Growing Abuse of Transfer Pricing by Transnational Corporations

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The large-scale tax avoidance practices used by transnational corporations (TNCs) came into public notice recently when the giant drug TNC, GlaxoSmithKline, agreed to pay the US government $3.4 billion to settle a long-running dispute over its tax dealings between the UK parent company and its American subsidiary. This was the largest settlement of a tax dispute in the US . The investigations carried out by Internal Revenue Service found that the American subsidiary of GlaxoSmithKline overpaid its UK parent company for drug supplies during 1989-2005 period, mainly its blockbuster drug, Zantac. These overpayments were meant to reduce the company's profit in the US and thereby its tax bill. The IRS charged the Europe 's largest drugs company for engaging in manipulative "transfer pricing."

What is transfer pricing? Transfer pricing is the price charged by one associate of a corporation to another associate of the same corporation. When one subsidiary of a corporation in one country sells goods, services or know-how to another subsidiary in another country, the price charged for these goods or services is called the transfer price. All kinds of transactions within the corporations are subject to transfer pricing including raw material, finished products, and payments such as management fees, intellectual property royalties, loans, interest on loans, payments for technical assistance and know-how, and other transactions. The rules on transfer pricing requires TNCs to conduct business between their affiliates and subsidiaries on an "arm's length" basis, which means that any transaction between two entities of the same TNC should be priced as if the transaction was conducted between two unrelated parties.

Transfer pricing, one of the most controversial and complex issues, requires closer scrutiny not only by the critics of TNCs but also by the tax authorities in the poor and the developing world. Transfer pricing is a strategy frequently used by TNCs to book huge profits through illegal means. The transfer price could be purely arbitrary or fictitious, therefore different from the price that unrelated firms would have had to pay. By manipulating a few entries in the account books, TNCs are able to reap obscene profits with no actual change in the physical capital. For instance, a Korean firm manufactures a MP3 player for $100, but its US subsidiary buys it for $199, and then sells it for $200. By doing this, the firm's bottom line does not change but the taxable profit in the US is drastically reduced. At a 30 per cent tax rate, the firm's tax liability in the US would be just 30 cents instead of $30.

TNCs derive several benefits from transfer pricing. Since each country has different tax rates, they can increase their profits with the help of transfer pricing. By lowering prices in countries where tax rates are high and raising them in countries with a lower tax rate, TNCs can reduce their overall tax burden, thereby boosting their overall profits. That is why one often finds that corporations located in high tax countries hardly pay any corporate taxes.

A study conducted by Simon J. Pak of Pennsylvania State University and John S. Zdanowicz of Florida State University found that US corporations used manipulative pricing schemes to avoid over $53 billion in taxes in 2001. Based on US import and export data, the authors found several examples of abnormally priced transactions such as toothbrushes imported from the UK into the US for a price of $5,655 each, flash lights imported from Japan for $5,000 each, cotton dishtowels imported from Pakistan for $153 each, briefs and panties imported from Hungary for $739 a dozen, car seats exported to Belgium for $1.66 each, and missile and rocket launchers exported to Israel for just $52 each.

With the removal of restrictions on capital flows, manipulative transfer pricing has increased manifold. According to UNCTAD’s World Investment Report 1996, one-third of world trade is basically intra-firm trade. Because of mergers and acquisitions, intra-firm trade, both in numbers and value terms, has increased considerably in recent years. Given that there are over 77,000 parent TNCs with over 770,000 foreign affiliates, the number of transactions taking place within these entities is unimaginable. Hence, it makes the task of tax authorities extremely difficult to monitor and control each and every transaction taking place within a particular TNC. The rapid expansion of Internet-based trading (E-commerce) has further complicated the task of national tax authorities.

Not only do TNCs reap higher profits by manipulating transfer pricing: there is also a substantial loss of tax revenue to countries, particularly developing ones, that rely more on corporate income tax to finance their development programs. Besides, governments are under pressure to lower taxes as a means of attracting investment or retaining a corporation’s operation in their country. This leads to a heavier tax burden on ordinary citizens for financing social and developmental programs. Although several instances of fictitious transfer pricing have come to public notice in recent years, there are no reliable estimates of the loss of tax revenue globally. The Indian tax authorities are expecting to garner an additional US$111 million each year from TNCs with the help of new regulations on transfer pricing introduced in 2001.

In addition, fictitious transfer pricing creates a substantial loss of foreign exchange and engenders economic distortions through fictitious entries of profits and losses. In countries where there are government regulations preventing companies from setting product retail prices above a certain percentage of prices of imported goods or the cost of production, TNCs can inflate import costs from their subsidiaries and then charge higher retail prices. Additionally, TNCs can use overpriced imports or underpriced exports to circumvent governmental ceilings on profit repatriation, thereby causing a drain of foreign exchange. For instance, if a parent TNC has a profitable subsidiary in a country where the parent does not wish to re-invest the profits, it can remit them by overpricing imports into that country. During the 1970s, investigations revealed that average overpricing by parent firms on imports by their Latin American subsidiaries in the pharmaceutical industry was as high as 155 per cent, while imports of dyestuff raw materials by TNC affiliates in India were overpriced in the range of 124 to 147 per cent.

Given the magnitude of manipulative transfer pricing, the Organization for Economic Co-operation and Development (OECD) has issued detailed guidelines. Transfer pricing regulations are extremely stringent in developed countries such as the US , the UK , and Australia . In the US , for instance, regulations related to transfer pricing cover almost 300 pages, which dent the myth that the US espouses “free market” policies.

However, developing countries are lagging behind in enacting regulations to check the abuse of transfer pricing. India framed regulations related to transfer pricing as late as 2001. However, many countries including Bangladesh , Pakistan , and Nepal , tax authorities have yet to enact regulations curbing the abuse of transfer pricing mechanisms. The abuse of transfer pricing mechanisms could be drastically curbed if there is an enhanced international coordination among national tax authorities.

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